CHAPTER

1

INTRODUCTION TO HEALTHCARE FINANCIAL MANAGEMENT

Learning Objectives

After studying this chapter, readers should be able to

- explain the difference between accounting and financial management;
- discuss the role of financial management in health services organizations;
- explain how the goals of investor-owned and not-for-profit businesses differ;
- describe, in general terms, the tax laws that apply both to individuals and to healthcare businesses; and
- assess the implications of health reform for the financial management of healthcare organizations.

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. Thus, the primary purpose of this textbook is to help healthcare managers and students become better decision makers. The text is designed primarily for nonfinancial managers, although financial specialists—especially those with accounting rather than finance backgrounds or those moving into the health services industry from other industries—will also find the text useful.

The major difference between this text and corporate finance texts is that this text focuses on factors unique to the health services industry. For

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example, the provision of health services is dominated by *not-for-profit or nonprofit* organizations (private and governmental), which are inherently different from *investor-owned* businesses.[1] Also, the majority of payments made to healthcare providers for services are not made by patients—the consumers of the services—but rather by some third-party payer (e.g., a commercial insurance company or a government program). This text emphasizes ways in which the unique features of the health services industry affect financial management decisions.

Although this text contains some theory and a great number of financial management concepts, its primary emphasis is on how managers can apply the theory and concepts; thus, it does not contain the traditional end-of-chapter questions and problems. (Note, however, that end-of-chapter problems in spreadsheet format are available as ancillary materials.) Rather, the text is designed to be used with the book *Cases in Healthcare Finance*, 5th edition, which contains cases based on real-life decisions faced by practicing healthcare managers. The cases are designed to enable students to apply the skills learned in this text's chapters in a realistic context, where judgment is just as critical to good decision making as numerical analysis. Furthermore, the cases are not directed, which means that although students receive some guidance, they must formulate their own approach to the analyses, just as real-world decision makers must do.[2]

This text and the casebook are oriented toward the use of spreadsheets that can help managers make better decisions. This text has accompanying spreadsheet models that illustrate the key concepts presented in many of the chapters. The casebook has spreadsheet models that make the quantitative portion of the case analyses easier to do and more complete.

It is impossible to create a text that includes everything that a manager needs to know about healthcare financial management. It would be foolish even to try because the industry is so vast and is changing so rapidly that many of the details needed to become completely knowledgeable in the field can be learned only through contemporary experience. Nevertheless, this text provides the core competencies readers need to (1) judge the validity of analyses performed by others, usually financial staff specialists or consultants, and (2) incorporate sound financial management theory and concepts in their own managerial and personal decision making.

How to Use This Book

The overriding goal in creating this text was to provide an easy-to-read, content-filled book on healthcare financial management. The text contains several features designed to assist in learning the material.

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First, pay particular attention to the Learning Objectives listed at the beginning of each chapter. These objectives give readers a feel for the most important topics in each chapter and set learning goals for that chapter. After each major section, except the Introduction, one or more Self-Test Questions are listed. Answers to these questions are not provided. When you finish reading each major section, try to provide reasonable answers to these questions. Your responses do not have to be perfect, but if you are not satisfied with your answer, reread that section before proceeding.

Within the book, italics and boldface are used to indicate special terms. *Italics* are used whenever a key term is introduced; thus, italics alert readers that a new or important concept is being presented. **Boldface** is used solely for emphasis; thus, the meaning of a boldface word or phrase has unusual significance to the point being discussed. Boxes are used to highlight key formulae or equations. As indicated in the Preface, the book has accompanying spreadsheet models that match—and sometimes expand on—selected calculations in the text. The sections of the text that have accompanying models are indicated by a Web icon (see the margin).

On the web at: *ache.org/books/UHFM7*

In addition to in-chapter learning aids (e.g., sidebars, time lines, solutions), materials designed to help readers learn healthcare financial management are included at the end of each chapter. First, many chapters contain an Integrative Application section that shows how a method covered in the chapter can be used to solve a practical problem. Second, a new feature called Chapter Supplement can be found immediately after many chapters; this includes materials that are important but not essential to the concepts discussed. Third, a summary section titled Chapter Key Concepts briefly reviews the most important topics covered in the chapter. If the meaning of a key concept is not apparent, you may want to review the applicable section. Fourth, a section called Chapter Models, Problems, and Mini-Cases indicates if spreadsheet models, problem sets, and mini-cases are available for that chapter. (See the Preface for more information on these ancillaries.) Finally, each chapter includes Selected Bibliography and Selected Websites. The books and articles listed in the bibliography can provide a more in-depth understanding of the material covered in the chapter, while the list of websites is designed to just scratch the surface of relevant material available online.

Taken together, the pedagogic structure of the book is designed to make the learning of healthcare financial management as easy and efficient as possible.

SELF-TEST QUESTION

1. Briefly describe the key features of the text designed to enhance the learning experience.

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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.

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- **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 third-party 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 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 participation in accountable care organizations and integrated delivery systems. 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

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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.

SELF-TEST QUESTIONS

1. What is the role of financial management in today's health services organizations?
2. How has this role changed over time?

Current Challenges

In January 2014, the American College of Healthcare Executives (ACHE) announced the top issues confronting hospitals.[3] Responses to a 2013 survey of 388 community hospital CEOs were used to determine these issues. The top five concerns identified by respondents are as follows:

1. Financial challenges
2. Health reform implementation
3. Government mandates
4. Patient safety and quality
5. Care for the uninsured

The specific financial challenges facing hospitals, as reported by the CEOs, are as follows:

- Government funding cuts
- Medicaid and Medicare reimbursement
- Bad debt
- Decreasing inpatient volume
- Increasing costs for staff, supplies, and so on
- Competition from other providers
- Inadequate funding for capital improvements
- Revenue cycle management (converting charges to cash)
- Other commercial insurance reimbursement
- Managed care payments
- Emergency departments

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Financial challenges were at the top of the list of hospital CEOs' concerns in 2013, just as they had been for the past ten years. As such, 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.

SELF-TEST QUESTION

1. What are some important issues confronting hospitals today?

Organizational Goals

This text focuses on business finance. Because most healthcare managers work for corporations and because not-for-profit businesses are organized as corporations, this text emphasizes this form of organization. The other forms of business organization and alternative forms of ownership are described in the Chapter Supplement (see the end of this chapter).

Financial decisions are not made in a vacuum but with an objective in mind. An organization's financial management goals must be consistent with and support the overall goals of the business. Thus, by discussing organizational goals, health services organizations develop a framework for financial decision making.

In a proprietorship, partnership, or small, privately owned corporation, the owners of the business generally are also its managers. In theory, the business can be operated for the exclusive benefit of the owners. If the owners want to work hard to maximize wealth, they can. On the other hand, if every Wednesday is devoted to golf, no one is hurt. (Of course, the business still has to cater to its customers or else it will not survive.) It is in large publicly owned corporations, in which owners and managers are separate parties, that organizational goals become most important.

Large, Investor-Owned Corporations

From a financial management perspective, the primary goal of investor-owned corporations is generally assumed to be *shareholder wealth maximization*, which translates to stock price maximization. Investor-owned corporations do, of course, have other goals. Managers, who make the decisions, are interested in their own personal welfare, in their employees' welfare, and in the good of the community and society at large. Still, the goal of stock price maximization is a reasonable operating objective on which to build financial decision rules.

The primary obstacle to shareholder wealth maximization as the goal of investor-owned corporations is the *agency problem*. An agency problem exists when one or more individuals (the *principals*) hire another individual or group of individuals (the *agents*) to perform a service on their behalf and

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then delegate a decision-making authority to those agents. In a healthcare financial management framework, the agency problem exists between stockholders and managers and between debtholders and stockholders.

The agency problem between stockholders and managers occurs because the managers of large, investor-owned corporations hold only a small proportion of the firm's stock, so they benefit little from stock price increases. On the other hand, managers often benefit substantially from actions detrimental to stockholders' wealth, such as increasing the size of the firm to justify higher salaries and more fringe benefits; awarding themselves generous retirement plans; and spending too much on such items as office space, personal staff, and travel. Clearly, many situations can arise in which managers are motivated to take actions that are in their best interests, rather than in the best interests of stockholders.

However, stockholders recognize the agency problem and counter it by creating the following mechanisms to keep managers focused on shareholder wealth maximization:

- **The creation of managerial incentives**. More and more firms are creating *incentive compensation plans* that tie managers' compensation to the firm's performance. One tool often used is *stock options*, which allow managers to purchase stock at some time in the future at a given price. Because the options are valuable only if the stock price climbs above the *exercise price* (the price that the managers must pay to buy the stock), managers are motivated to take actions to increase the stock price. However, because a firm's stock price is a function of both managers' actions and the general state of the economy, a firm's managers could be doing a superlative job for shareholders but the options could still be worthless. To overcome the inherent shortcoming of stock options, many firms use *performance shares* as the managerial incentive. Performance shares are given to managers on the basis of the firm's performance as indicated by objective measures, such as earnings per share, return on equity, and so on. Not only do managers receive more shares when targets are met; the value of the shares is also enhanced if the firm's stock price rises. Finally, many businesses use the concept of *economic value added (EVA)* to structure managerial compensation. (EVA is discussed in Chapter 13.) All incentive compensation plans—stock options, performance shares, profit-based bonuses, and so forth—are designed with two purposes in mind. First, they offer managers incentives to act on factors under their control in a way that will contribute to stock price maximization. Second, such plans help firms attract and retain top-quality managers.[4]
- **The threat of firing**. Until the 1980s, the probability of a large firm's stockholders ousting its management was so remote that it

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posed little threat. Ownership of most firms was so widely held, and management's control over the proxy (voting) mechanism was so strong, that it was almost impossible for dissident stockholders to fire a firm's managers. Today, however, about 70 percent of the stock of an average large corporation, such as pension funds and mutual funds, is held by institutional investors rather than individual investors. These institutional money managers have the clout, if they choose to use it, to exercise considerable influence over a firm's managers and, if necessary, to remove the current management team by voting it off the board.

- **The threat of takeover**. A *hostile takeover*—the purchase of a firm against its management's wishes—is most likely to occur when a firm's stock is undervalued relative to its potential because of poor management. In a hostile takeover, a potential acquirer makes a direct appeal to the shareholders of the target firm to tender, or sell, their shares at some stated price. If 51 percent of the shareholders agree to tender their shares, the acquirer gains control. When a hostile takeover occurs, the managers of the acquired firm often lose their jobs, and any managers permitted to stay generally lose the autonomy they had prior to the acquisition. Thus, managers have a strong incentive to take actions to maximize stock price. In the words of the president of a major drug manufacturer, "If you want to keep control, don't let your company's stock sell at a bargain price."

In summary, managers of investor-owned firms can have motivations that are inconsistent with shareholder wealth maximization. Still, sufficient mechanisms are at work to force managers to view shareholder wealth maximization as an important, if not primary, goal. Thus, shareholder wealth maximization is a reasonable goal for investor-owned firms.

Not-for-Profit Corporations

Because not-for-profit corporations do not have shareholders, shareholder wealth maximization is not an appropriate goal for such organizations. Not-for-profit firms consist of a number of classes of *stakeholders* who are directly affected by the organization. Stakeholders include all parties who have an interest—usually financial—in the organization. For example, a not-for-profit hospital's stakeholders include the board of trustees, managers, employees, physicians, creditors, suppliers, patients, and even potential patients (who may include the entire community). An investor-owned hospital has the same set of stakeholders, plus one additional class—stockholders. While managers of investor-owned firms have to please only one class of stakeholders—the shareholders—managers of not-for-profit firms face a different situation. They have to please all of the organization's stakeholders because no single, well-defined group exercises control.

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Many people argue that managers of not-for-profit firms do not have to please anyone because they tend to dominate the board of trustees, who are supposed to exercise oversight. Others argue that managers of not-for-profit firms have to please all of the firm's stakeholders because all are necessary to the successful performance of the business. Of course, even managers of investor-owned firms should not attempt to enhance shareholder wealth by treating any of their firm's other stakeholders unfairly because such actions ultimately will be detrimental to shareholders.

Typically, the goal of not-for-profit firms is stated in terms of a mission. An example is the mission statement of Bayside Memorial Hospital, a 450-bed, not-for-profit, acute care hospital:

> Bayside Memorial Hospital, along with its medical staff, is a recognized, innovative healthcare leader dedicated to meeting the needs of the community. We strive to be the best comprehensive healthcare provider through our commitment to excellence.

Although this mission statement provides Bayside's managers and employees with a framework for developing specific goals and objectives, it does not provide much insight into the goals of the hospital's finance function. For Bayside to accomplish its mission, its managers have identified five financial goals:

1. The hospital must maintain its financial viability.
2. The hospital must generate sufficient profits to continue to provide its current range of healthcare services to the community. Buildings and equipment must be replaced as they become obsolete.
3. The hospital must generate sufficient profits to invest in new medical technologies and services as they are developed and needed.
4. The hospital should not rely on its philanthropy program or government grants to fund its operations and growth, although it will aggressively seek such funding.
5. The hospital will strive to provide services to the community as inexpensively as possible, given the above financial requirements.

In effect, Bayside's managers are saying that to achieve the hospital's commitment to excellence as stated in its mission statement, the hospital must remain financially strong and profitable. Financially weak organizations cannot continue to accomplish their stated missions over the long run. What is interesting is that Bayside's five financial goals are probably not much different from the financial goals of Jefferson Regional Medical Center (JRMC), a for-profit competitor. Of course, JRMC has to worry about providing a

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return to its shareholders, and it receives only a small amount of contributions and grants. To maximize shareholder wealth, JRMC also must retain its financial viability and have the financial resources necessary to offer new services and technologies. Furthermore, competition in the market for hospital services will not permit JRMC to charge appreciably more for services than its not-for-profit competitors.

SELF-TEST QUESTIONS

1. What is the difference between the goals of investor-owned and not-for-profit firms?
2. What is the agency problem, and how does it apply to investor-owned firms?
3. What factors tend to reduce the agency problem?

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 an MRI [magnetic resonance imaging] 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 do not attempt to cover them in this text. Rather, we focus on the federal income tax system because these taxes dominate the taxation of business income. In our examples, we 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 gives 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.

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Current (2013) federal income tax rates on **personal income** go up to 39.6 percent, and when state and local income taxes are added, the marginal rate can approach 54 percent. **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 54 percent. Corporate income, in addition to state and local income taxes, is taxed by the federal government at marginal rates as high as 40 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.

Individual (Personal) Income Taxes

Individuals pay personal taxes on wages and salaries; on investment income such as dividends, interest, and profits from the sale of securities; and on the profits of sole proprietorships, partnerships, and S corporations. For tax purposes, investors receive two types of income: (1) ordinary and (2) dividends and capital gains. *Ordinary income* includes wages and salaries and interest income. *Dividend income* (which arises from stock ownership) and *capital gains* (which arise from the sale of assets, including stocks) generally are taxed at lower rates than are ordinary income.

Taxes on Wages and Salaries

Federal income taxes on ordinary income are **progressive**—that is, the higher one's income, the larger the *marginal tax rate*, which is the rate applied to the last dollar of earnings. Marginal rates on ordinary income begin at 10 percent; then rise to 15, 25, 28, and 35 percent; and finally top out at 39.6 percent. Because the levels of income for each bracket are adjusted for inflation annually, and because the brackets are different for single individuals and married couples who file a joint return, we do not provide a complete discussion here. In brief, in 2014 it takes a taxable income of $450,000 for married couples to be in the highest (39.6 percent) bracket, so most people fall into the lower brackets.

Taxes on Interest Income

Individuals can receive *interest income* on savings accounts, certificates of deposit, bonds, and the like. Like wages and salaries, interest income is taxed as ordinary income and hence is taxed at federal rates of up to 39.6 percent, in addition to applicable state and local income taxes.

Note, however, that under federal tax laws, interest on most state and local government bonds, called *municipals* or *munis*, is not subject to federal income taxes. Such bonds include those issued by municipal healthcare authorities on behalf of not-for-profit healthcare providers. Thus, investors

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get to keep all of the interest received from municipal bonds but only a proportion of the interest received from bonds issued by the federal government or by corporations. Therefore, a lower interest rate muni bond can provide the same or higher after-tax return as a higher yielding corporate or Treasury bond. For example, consider an individual in the 35 percent federal tax bracket who can buy a taxable corporate bond that pays a 10 percent interest rate. What rate would a similar-risk muni bond have to offer to make the investor indifferent between it and the corporate bond?

Here is a way to think about this problem:

$$\begin{aligned}\text{After-tax rate on corporate bond} &= \text{Pretax rate} - \text{Yield lost to taxes}\\ &= \text{Pretax rate} - \text{Pretax rate} \times \text{Tax rate}\\ &= \text{Pretax rate} \times (1 - \text{T})\\ &= 10\% \times (1 - 0.35) = 10\% \times 0.65 = 6.5\%.\end{aligned}$$

Here, *T* is the investor's marginal tax rate. Thus, the investor would be indifferent between a corporate bond with a 10 percent interest rate and a municipal bond with a 6.5 percent rate.

If the investor wants to know what yield on a taxable bond is equivalent to, say, a 7.0 percent interest rate on a muni bond, he would follow this procedure:

$$\begin{aligned}&\text{Equivalent rate on taxable bond} = \text{Rate on municipal bond} / (1 - \text{T})\\ &= 7.0\% / (1 - 0.35) = 7.0\% / 0.65 = 10.77\%.\end{aligned}$$

The exemption of municipal bonds from federal taxes stems from the separation of power between the federal government and state and local governments, and its primary effect is to allow state and local governments (as well as not-for-profit healthcare providers) to borrow at lower interest rates than otherwise would be possible.

Dividend Income

In addition to interest income on securities, investors can receive dividend income from securities (stocks). Because investor-owned corporations pay dividends out of earnings that have already been taxed, there is double taxation on corporate income. Because taxes have already been paid on these earnings, dividend income is taxed at the same rates as long-term capital gains income; these rates are lower than those on ordinary and interest income. If an individual is in the 25 percent or higher tax bracket, dividends are taxed at 15 percent. If an individual is in the 10 or 15 percent tax bracket, dividends are taxed at only 5 percent. To see the advantage, consider an individual in

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the 35 percent tax bracket who receives both $100 in interest income and $100 in dividend income. The taxes on the interest income would be 0.35 × $100 = $35, while the taxes on the dividend income would be only 0.15 × $100 = $15, a difference of $20.[5]

Capital Gains Income

Assets such as stocks, bonds, real estate, and property and equipment (land, buildings, X-ray machines, and the like) are defined as *capital assets*. If an individual buys a capital asset and later sells it at a profit—that is, if the individual sells it for more than the purchase price—the profit is called a *capital gain*. If the individual sells it for less than the purchase price, the loss is called a *capital loss*. An asset sold within one year of the time it was purchased produces a short-term capital gain or loss, whereas an asset held for more than one year produces a long-term capital gain or loss. For example, if you buy 100 shares of Tenet Healthcare for $10 per share and sell the stock later for $15 per share, you will realize a capital gain of 100 × ($15 – $10) = 100 × $5 = $500. However, if you sell the stock for $5 per share, you will incur a capital loss of $500. If you hold the stock for one year or less, the gain or loss is short term; otherwise, it is a long-term gain or loss. Note that if you sell the stock for $10 a share, you will realize neither a capital gain nor loss; you will simply get your $1,000 back, and no taxes will be due on the transaction.

Short-term capital gains are taxed as ordinary income at the same rates as wages and interest. However, long-term capital gains are taxed at the same rates as dividends; these rates are lower than those on ordinary income. For an illustration of the effect of this tax benefit on long-term capital gains, consider an investor in the top 35 percent tax bracket who makes a $500 long-term capital gain on the sale of Tenet Healthcare stock. If the $500 were ordinary income, she would have to pay federal income taxes of 0.35 × $500 = $175. However, as a long-term capital gain, the tax would be only 0.15 × $500 = $75, for a savings of $100 in taxes. There are many nuances to capital gains taxes, especially regarding the effect of losses on taxes. Our purpose is merely to introduce the concept.

The purpose of the reduced tax rate on dividends and long-term capital gains is to encourage individuals to invest in assets that contribute most to economic growth.

Corporate Income Taxes

The corporate tax structure, shown in Exhibit 1.1, has marginal rates as high as 39 percent, which brings the average rate up to 35 percent. For example, if Midwest Home Health Services, an investor-owned home health care business headquartered in Chicago, had $80,000 of taxable income, its federal income tax bill would be $15,450:

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EXHIBIT 1.1
Corporate Tax Rates for 2014

Taxable Income	*Tax*	*Average Tax Rate at Top of Bracket*
Up to $50,000	15% of taxable income	15.0%
$50,001–$75,000	$7,500 + 25% of excess over $50,000	18.3%
$75,001–$100,000	$13,750 + 34% of excess over $75,000	22.3%
$100,001–$335,000	$22,250 + 39% of excess over $100,000	34.0%
$335,001–$10,000,000	$113,900 + 34% of excess over $335,000	34.0%
$10,000,001–$15,000,000	$3,400,000 + 35% of excess over $10,000,000	34.3%
$15,000,001–$18,333,333	$5,150,000 + 38% of excess over $15,000,000	35.0%
Over $18,333,333	$6,416,667 + 35% of excess over $18,333,333	35.0%

$$\begin{aligned}\text{Corporate taxes} &= \$13{,}750 + [0.34 \times (\$80{,}000 - \$75{,}000)] \\ &= \$13{,}750 + (0.34 \times \$5{,}000) \\ &= \$13{,}750 + \$1{,}700 = \$15{,}450.\end{aligned}$$

Midwest's marginal tax rate would be 34 percent, but its average tax rate would be $15,450/$80,000 = 19.3%. Note that the average federal corporate income tax rate is progressive to $18,333,333 of income, but it is constant thereafter.

Unrelated Business Income

Even though tax-exempt holding companies can be created with both tax-exempt and taxable subsidiaries, tax-exempt corporations can have taxable income, which is usually referred to as *unrelated business income (UBI)*. UBI is created when a tax-exempt corporation has income from a trade or business that (1) is not substantially related to the charitable goal of the organization and (2) is carried on with the frequency and regularity of comparable for-profit commercial businesses.

As an example of UBI, consider Bayside Memorial Hospital's pharmacy sales. In addition to its services to the hospital's patients, the not-for-profit hospital's pharmacy has a second location, adjacent to the parking garage, which sells drugs and supplies to the general public. In general, the Internal Revenue Service (IRS) views the charitable purpose of a hospital as providing healthcare services to its patients, so the income from Bayside's sales of drugs and supplies to nonpatients is taxable. The fact that the profits

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from the sales are used for charitable purposes is immaterial. Note, however, that if the trade or business in which a not-for-profit entity is engaged (1) is run by volunteers, (2) is run for the convenience of its employees, or (3) involves the sale of merchandise contributed to the organization, the income generated remains tax exempt. Thus, the profits on Bayside's sales of drugs and supplies to its employees, as well as the profits on the sale of items in its gift shop run by volunteers, are exempt from taxation.

Not-for-profit organizations must file UBI tax returns with the IRS annually if their gross income from unrelated business activity exceeds $1,000. Taxable income is determined by deducting expenses related to UBI income production from gross income. Then, taxes are calculated as if the income were earned by a taxable corporation.

Interest and Dividend Income Received by an Investor-Owned Corporation

Interest income received by a taxable corporation is taxed as ordinary income at the regular tax rates contained in Exhibit 1.1. However, a portion of the dividends received by one corporation from another is excluded from taxable income. As we mention in our discussion of holding companies, the size of the dividend exclusion depends on degree of ownership. In general, we assume that corporations that receive dividends have only nominal ownership in the dividend-paying corporations, so 30 percent of the dividends received are taxable. The purpose of the dividend exclusion is to lessen the impact of triple taxation. Triple taxation occurs when the earnings of Firm A are taxed; then dividends are paid to Firm B, which must pay partial taxes on the income; and then Firm B pays out dividends to Individual C, who must pay personal taxes on the income.

To see the effect of the dividend exclusion, consider the following example. A corporation that earns $500,000 and pays a 34 percent marginal tax rate would have an *effective tax rate* of only $0.30 \times 0.34 = 0.102 = 10.2\%$ on its dividend income. If this firm had $10,000 in pretax dividend income, its after-tax dividend income would be $8,980:

$$\begin{aligned}
\text{After-tax income} &= \text{Pretax income} - \text{Taxes} \\
&= \text{Pretax income} - (\text{Pretax income} \times \text{Effective tax rate}) \\
&= \text{Pretax income} \times (1 - \text{Effective tax rate}) \\
&= \$10{,}000 \times [1 - (0.30 \times 0.34)] \\
&= \$10{,}000 \times (1 - 0.102) = \$10{,}000 \times 0.898 = \$8{,}980.
\end{aligned}$$

If a taxable corporation has surplus funds that can be temporarily invested in securities, the tax laws favor investment in stocks (which pay dividends) rather than in bonds (which pay interest). For example, suppose

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Midwest Home Health Services has $100,000 to invest temporarily, and it can buy either bonds that pay interest of $8,000 per year or preferred stock that pays dividends of $7,000 per year. Because Midwest is in the 34 percent tax bracket, its tax on the interest if it bought the bonds would be 0.34 × $8,000 = $2,720, and its after-tax income would be $8,000 – $2,720 = $5,280. If it bought the preferred stock, its tax would be 0.34 × (0.30 × $7,000) = $714, and its after-tax income would be $6,286. Other factors might lead Midwest to invest in the bonds or other securities, but the tax laws favor stock investments when the investor is a corporation.

Interest and Dividend Income Received by a Not-for-Profit Corporation

Interest income and dividend income received from securities purchased by not-for-profit corporations with **temporary surplus** cash are not taxable. However, note that not-for-profit firms are prohibited from issuing tax-exempt bonds for the sole purpose of reinvesting the proceeds in other securities, although they can temporarily invest the proceeds from a tax-exempt issue in taxable securities while waiting for the planned expenditures to occur. If not-for-profit firms could engage in such tax arbitrage operations, they could, in theory, generate an unlimited amount of income by issuing tax-exempt bonds for the sole purpose of investing in higher-yield securities that are taxable to most investors. For example, a not-for-profit firm might sell tax-exempt bonds with an interest rate of 5 percent and use the proceeds to invest in US Treasury bonds that yield 6 percent.

Interest and Dividends Paid by an Investor-Owned Corporation

A firm's assets can be financed with either debt or equity capital. If it uses debt financing, it must pay interest on that debt, whereas if an investor-owned firm uses equity financing, normally it will pay dividends to its stockholders. The interest paid by a taxable corporation is deducted from the corporation's operating income to obtain its taxable income, but dividends are not deductible. Put another way, dividends are paid from after-tax income. Therefore, Midwest, which is in the 34 percent tax bracket, needs only $1 of pretax earnings to pay $1 of interest expense, but it needs $1.52 of pretax earnings to pay $1 in dividends:

$$\text{Dollars of pretax income required} = \frac{\$1}{(1 - \text{Tax rate})}$$

$$= \frac{\$1}{0.66} = \$1.52.$$

The fact that interest is a tax-deductible expense, while dividends are not, has a profound impact on the way taxable businesses are financed. The

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US tax system favors debt financing over equity financing. This point is discussed in detail in Chapter 10.

Corporate Capital Gains

At one time, corporate long-term capital gains were taxed at lower rates than were ordinary income. However, under current law, corporate capital gains are taxed at the same rate as operating income.

Corporate Loss Carry-Back and Carry-Forward

Corporate operating losses that occur in any year can be used to offset taxable income in other years. In general, such losses can be carried back to each of the preceding two years and forward for the next 20 years. For example, an operating loss by Midwest Home Health Services in 2014 would be applied first to 2012. If Midwest had taxable income in 2012 and hence paid taxes, the loss would be used to reduce 2012's taxable income, so the firm would receive a refund on taxes paid for that year. If the 2014 loss exceeded the taxable income for 2012, the remainder would be applied to reduce taxable income for 2013. If Midwest did not have to use the 2014 loss to offset 2013 or 2012 profits, the loss for 2014 would be carried forward to 2015, 2016, and so on—up to 2034. Note that losses that are carried back provide immediate tax benefits, but the tax benefits of losses that are carried forward are delayed until sometime in the future. The tax benefits of losses that cannot be used to offset taxable income in 20 years or less are lost to the firm. The purpose of this provision in the tax laws is to avoid penalizing corporations whose incomes fluctuate substantially from year to year.

Consolidated Tax Returns

As we mention later, if a corporation owns 80 percent or more of another corporation's stock, it can aggregate income and expenses and file a single consolidated tax return. Thus, the losses of one firm can be used to offset the profits of another. No business wants to incur losses (it can go broke losing $1 to save 34 cents in taxes), but tax offsets do make it more feasible for large multicompany businesses to undertake risky new ventures that might suffer start-up losses.

SELF-TEST QUESTIONS

1. Briefly explain the individual (personal) and corporate income tax systems.
2. What is the difference in individual tax treatment between interest and dividend income?
3. What are capital gains and losses, and how are they differentiated from ordinary income?

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SELF-TEST QUESTIONS

4. What is unrelated business income?
5. How do federal income taxes treat dividends received by corporations compared to dividends received by individuals?
6. With regard to investor-owned businesses, do tax laws favor financing by debt or by equity? Explain your answer.

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

EXHIBIT 1.2
The Effect of Depreciation on Cash Flow

	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

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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.

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 with 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

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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.

Depreciable Basis

The *depreciable basis* is a critical element of the depreciation calculation because each year's recovery allowance depends on the asset's depreciable basis and its recovery period. The depreciable basis under MACRS generally is equal to the purchase price of the asset plus any transportation and installation costs. Unlike the calculation of book depreciation, the basis for MACRS depreciation is **not** adjusted for salvage value regardless of whether the standard accelerated method or alternative straight-line method is used.

MACRS Recovery Periods

Exhibit 1.3 describes the general types of property that fit into each *recovery period*. Property in the 27.5- and 39-year classes (real estate) must be depreciated using the alternate straight-line method, but 3-, 5-, 7-, and 10-year property (personal property) can be depreciated by either the standard accelerated method or the alternative straight-line method.

EXHIBIT 1.3
MACRS Recovery Periods

Period	*Type of Property*
3-year	Tractor units and certain equipment used in research
5-year	Automobiles, trucks, computers, and certain special manufacturing tools
7-year	Most equipment, office furniture, and fixtures
10-year	Certain longer-lived types of equipment
27.5-year	Residential rental property, such as apartment buildings
39-year	All nonresidential property, such as commercial and industrial buildings

Note: Land cannot be depreciated.

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MACRS Recovery Allowances

Once the property is placed in the correct recovery period, the yearly recovery allowance, or depreciation expense, is determined by multiplying the asset's depreciable basis by the appropriate recovery percentage shown in Exhibit 1.4. The calculation is discussed in the following sections.

Under MACRS, it is generally assumed that an asset is placed in service in the middle of the first year. Thus, for 3-year recovery period property, depreciation begins in the middle of the year the asset is placed in service and ends three years later. The effect of the *half-year convention* is to extend the recovery period one more year, so 3-year property is depreciated over four calendar years, 5-year property is depreciated over six calendar years, and so on. This convention is incorporated in the values listed in Exhibit 1.4.

MACRS Depreciation Illustration

Assume that the $100,000 X-ray machine is purchased by Northside Family Practice and placed in service in 2014. Furthermore, assume that Northside paid another $10,000 to ship and install the machine and that the machine falls into the MACRS 5-year class. Because salvage value does not play a part in tax depreciation, and because delivery and installation charges are included (are capitalized) in the basis rather than expensed in the year incurred, the machine's depreciable basis is $110,000.

Each year's recovery allowance (tax depreciation expense) is determined by multiplying the depreciable basis by the applicable recovery

EXHIBIT 1.4
MACRS Recovery Allowances

Ownership	*Recovery Period*			
Year	3-Year	5-Year	7-Year	10-Year
1	33%	20%	14%	10%
2	45	32	25	18
3	15	19	17	14
4	7	12	13	12
5		11	9	9
6		6	9	7
7			9	7
8			4	7
9				7
10				6
11				3
	100%	100%	100%	100%

Note: The tax tables carry the recovery allowances to two decimal places, but for ease of illustration, we will use the rounded allowances shown in this table throughout this text.

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percentage. Thus, the depreciation expense for 2014 is 0.20 × $110,000 = $22,000, and for 2015 it is 0.32 × $110,000 = $35,200. Similarly, the depreciation expense is $20,900 for 2016, $13,200 for 2017, $12,100 for 2018, and $6,600 for 2019. The total depreciation expense over the six-year recovery period is $110,000, which equals the depreciable basis of the X-ray machine. Note that the depreciation expense reported for tax purposes each year is different from the book depreciation reported on Northside's income statement, which we calculated earlier.

The *book value* of a depreciable asset at any point in time is its depreciable basis minus the depreciation accumulated to date. Thus, at the end of 2014, the X-ray machine's tax book value is $110,000 – $22,000 = $88,000; at the end of 2015, the machine's tax book value is $110,000 – $22,000 – $35,200 = $52,800 (or $88,000 – $35,200 = $52,800); and so on. Again, note that the book value for accounting purposes is different from the book value for tax purposes.

According to the IRS, the value of a depreciable asset at any point in time is its tax book value. If a business sells an asset for more than its tax book value, the implication is that the firm took too much depreciation, and the IRS will want to recover the excess tax benefit. Conversely, if an asset is sold for less than its book value, the implication is that the firm did not take sufficient depreciation, and it can take additional depreciation on the sale of the asset. For example, suppose Northside sells the X-ray machine in early 2016 for $60,000. Because the machine's tax book value is $52,800 at the time, $60,000 – $52,800 = $7,200 is added to Northside's operating income and taxed. Conversely, if Northside received only $40,000 for the machine, it would be able to deduct $52,800 – $40,000 = $12,800 from taxable income and hence reduce its taxes in 2016.

SELF-TEST QUESTIONS

1. Briefly describe the MACRS tax depreciation system.
2. What is the effect of the sale of a depreciable asset on a firm's taxes?

Health Reform and Financial Management

The *Patient Protection and Affordable Care Act (ACA)* of 2010 has been called the "most significant health care legislation since Medicare and Medicaid in 1965." The new law was enacted on March 23, 2010, and was designed to provide all US citizens and legal residents with access to affordable health insurance, to reduce healthcare costs, and to improve care and quality. This legislation puts in place comprehensive health insurance changes to expand coverage, hold insurance companies accountable, lower costs,

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guarantee more choices, and enhance the quality of care—all of which are intended to transform and make the US healthcare system more sustainable.

The ACA has numerous major aims. However, the central goal is to expand healthcare coverage through shared responsibility between government, individuals, and employers. This involves requiring all US citizens and legal residents to have health insurance coverage, which may be acquired through health insurance exchanges at affordable or income-based costs (if they are self-employed, they are unemployed, or their employers do not offer insurance). Employers are required to offer direct coverage to employees or indirect coverage through the provision of tax credits. Public programs such as Medicare and Medicaid have expanded eligibility requirements to cover qualified individuals and families with incomes less than 133 percent of the federal poverty level. These changes are intended to reduce the number of uninsured by half and provide coverage for about 94 percent of Americans. In addition, these reforms are intended to reduce healthcare expenditures by $100 billion in the next ten years by controlling overspending, waste, fraud, and abuse.

Some of the benefits of the ACA include free preventive care, no preexisting-condition limitation, prescription discounts for seniors, protection against healthcare fraud, small-business tax credits, extended coverage for young adults, lifetime coverage on most benefits, prevention of coverage cancellation, transparency on increases in insurance premium rates, and patient selection of primary care doctors from network.

The major implications of health reform for health insurance and provider payments are addressed in chapters 2 and 3, respectively. The major implications of health reform for the institutional setting and the delivery of healthcare services are discussed in this section.

Accountable Care Organizations

An *accountable care organization (ACO)* is one of the ways the ACA seeks to decrease healthcare costs. An ACO is a network of doctors, other clinicians, and hospitals and clinics that shares responsibility for providing coordinated care to patients. Providers in an ACO are not only jointly accountable for the health of their patients but also receive financial incentives to cooperate and save money by avoiding unnecessary tests and procedures, eliminating duplication of services, and coordinating patients' care.

ACOs can include hospitals, specialists, post-acute providers, and even private companies. The only required member of an ACO is a primary care physician, who serves as the lead of the program. More than half of the Medicare ACOs that exist today are run by physicians and do not include a hospital partner.

An ACO can take on many forms, such as the following:

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- An integrated delivery system that has common ownership of hospitals and physician practices and has electronic medical records, team-based care, and resources to support cost-effective care
- A multispecialty group practice that has strong affiliations with hospitals and contracts with multiple health plans
- A physician–hospital organization that is a subset of a hospital's medical staff and that functions like a multispecialty group practice
- An independent practice association comprising individual physician practices that come together to contract with health plans
- A virtual physician organization that sometimes includes physicians in rural areas

ACOs are paid through the traditional fee-for-service system; however, they are offered bonuses as an incentive to keep costs of care down. Doctors and hospitals have to meet specific quality benchmarks that focus on prevention and careful management of patients with chronic diseases. In other words, providers get paid more for keeping patients healthy and out of the hospital. If an ACO is unable to save money, it could be liable for the costs of the investments made to improve care; it also may have to pay a penalty if it does not meet performance and savings benchmarks. The US Department of Health and Human Services estimates that ACOs could save Medicare up to $940 million in the first four years of their operation.

Industry Consolidation

Health reform is driving the consolidation of healthcare organizations. The ACA has accelerated health systems' acquisition of hospitals and hospitals' acquisition of physician practices, and that is likely to continue over the next several years. With the greater focus on clinical integration, quality patient care, and changing reimbursement, healthcare organizations are seeking to restructure healthcare delivery to operate more efficiently and improve coordination between patients and providers. Healthcare organizations are looking to gain a competitive advantage from combining assets, staff, and resources. Consolidation not only provides organizations access to capital, economies of scale, and market share but may also lead to improvement in patient care by making it easier to share patient information, adhere to clinical practice guidelines (thus reducing variations in care), and access high-quality specialist physicians.

Population Health

Health reform is moving providers toward the population health management approach. The goal of population health management is to shift from focusing on treating illness to maintaining or improving health to prevent costly

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avoidable illness and unnecessary care, which is supported by new reimbursement models like capitation, payment bundling, and shared savings. Instead of just providing preventive and chronic care when patients come in for acute problems, practices track and monitor the health status of the entire patient population, requiring greater use of health information technology. The key to success in population health management will be greater awareness of the health status of the population and proactive intervention to reduce use of the health system and to achieve the best population outcomes.

Clinical Integration

A fundamental component to achieving the goals of the ACA and other health reform efforts is clinical integration. Clinical integration aims to coordinate patient care across conditions, providers, settings, and time to achieve care that is safe, timely, effective, efficient, and patient focused. New payment models and advances in health information systems are used to facilitate the transition to the clinical integration model and to manage the continuum of care for patients. Provider payments are tied to results for quality, access, and efficiency with the objective of establishing coordination between hospitals and physicians. Health information technology aims to capture patient information and make it accessible to authorized providers at the point of care. Complete patient information facilitates optimal treatment strategies and reduces the chance of medication errors and conflicting treatment plans. There will be requirements for new and more comprehensive policies and procedures that protect patient privacy and that guarantee secure data that are transferred between patients, caregivers, and organizations.

Data Analytics

ACOs and an increasing emphasis on collaboration between clinicians and on quality patient care are making it necessary for healthcare organizations to invest in integrated information systems technology to collect large quantities of patient and provider data (so-called *big data*). Data analytic systems are capable of analyzing large amounts of patient data to better understand clinical processes and to identify problems and opportunities for improvement in the provision of healthcare services. Complex, new information technology will facilitate analysis of care coordination, patient safety, and utilization of healthcare services.

Staffing Shortages

Health reform is expected to increase the number of patients who can access the healthcare system. Healthcare organizations will see an influx of formerly uninsured patients now seeking care because they have insurance or better coverage. As a result, the demand for healthcare professionals—especially physicians, nurse practitioners, and physician assistants—will likely increase.

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Health reform is also driving changes in hospital staffing by emphasizing prevention and value-based care, creating demand for primary care providers, emergency physicians, clinical pharmacists, and health information technology and data specialists. Some professional and industry associations are predicting that current shortages of various healthcare staff will worsen in the face of this growing demand. The ACA has identified several strategies to increase the supply of health professionals (including primary care physicians), such as scholarships and flexible loan repayment programs. However, many healthcare organizations likely will face great competition for some healthcare staff.

SELF-TEST QUESTIONS

1. Briefly describe the major changes under the ACA.
2. What are the major implications of health reform for financial management of healthcare organizations?

Chapter Key Concepts

This chapter presented some background information on business organization, ownership, goals, and taxes. Here are its key concepts:

- Financial management is a *decision science*, so the primary objective of this text is to provide students and practicing healthcare managers with the theory, concepts, and tools necessary to make effective decisions. The text is structured to support this goal.
- The *primary role of financial management* is to plan for, acquire, and utilize funds to maximize the efficiency and value of an enterprise.
- Financial management functions include (1) *evaluation and planning*, (2) *long-term investment decisions*, (3) *financing decisions*, (4) *working capital management*, (5) *contract management*, and (6) *financial risk management*.
- Although each form of organization has unique advantages and disadvantages, most large organizations and all not-for-profit entities are organized as *corporations*.
- From a financial management perspective, the goal of investor-owned firms is *shareholder wealth maximization*, which translates to stock price maximization. For not-for-profit firms, a reasonable goal for financial management is to *ensure the organization can*

(continued)

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fulfill its mission, which translates to *maintaining the organization's financial viability*.

- An *agency problem* is a potential conflict of interest between principals and agents. One type of agency problem that can arise in financial management is conflict between the owners and managers of a for-profit corporation.
- The value of any income stream depends on the amount of *usable*, or *after-tax*, *income*. Thus, tax laws play an important role in financial management decisions.
- Separate tax laws apply to *personal* income and *corporate* income.
- Fixed assets are *depreciated* over time to reflect the decline in their values. Depreciation is a deductible, but noncash, expense. Thus, for a taxable entity, the higher its depreciation, the lower its taxes and hence the higher its cash flow, with other things held constant.
- Current laws specify that the *Modified Accelerated Cost Recovery System (MACRS)* be used to depreciate assets for tax purposes.
- The *Patient Protection and Affordable Care Act (ACA)* of 2010 aims to provide all US citizens and legal residents with access to affordable health insurance options and to transform the healthcare system to reduce costs.
- *Accountable care organizations (ACOs)* are one of the ways the ACA seeks to reduce healthcare costs. This type of organization is made up of a network of doctors, other clinicians, and hospitals and clinics that shares responsibility for providing coordinated care to patients with the intention of reducing unnecessary spending.

Although this chapter provides a great deal of background information relevant to healthcare financial management and the changes associated with health reform, it is necessary to have a more thorough understanding of the reimbursement system. This important topic is covered in Chapter 2.

Chapter Models, Problems, and Mini-Cases

This chapter does not have an accompanying spreadsheet model. However, the chapter has five problems in spreadsheet format that focus on tax issues.

The problem spreadsheets can be accessed on this book's companion website at ache.org/books/UHFM7.

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Selected Websites

The following websites pertain to the content of this chapter:

- For more information on taxes, go to www.taxfoundation.org.
- To get a feel for the services offered by a corporate alliance, see the VHA site at www.vha.com.
- Two of the largest integrated health systems in the United States are Kaiser Permanente and the Henry Ford Health System. To gain a better idea of what constitutes such systems, visit www.kaiserpermanente.org or www.henryfordhealth.org.
- For more information on health reform, go to www.whitehouse.gov/healthreform.
- For more information on the Affordable Care Act and accountable care organizations, go to www.accountablecarefacts.org.

Notes

1. Not-for-profit organizations are also called *nonprofit* organizations, but the former designation is becoming dominant in the health services industry. Also, investor-owned businesses are sometimes called *proprietary*, or *for-profit*, businesses.
2. There is a set of questions for each case in the online Instructor's Resources that accompany the casebook. Instructors who want to provide more guidance to students than that given in the case itself can distribute these questions to their students.
3. For additional information see, www.ache.org/pubs/Releases/2014/top-issues-confronting-hospitals-2013.cfm.
4. Not-for-profit organizations also use incentive compensation plans. For more information, see Ackerman, K., W. E. Kibler Jr., G. D. Steele Jr., R. L. Van Horn, and K. Swartz. 2005. "Executive Compensation in Nonprofit Health Care Organizations." *Inquiry* 42 (2): 110–17.
5. Tax rates are constantly changing, so it is important to ensure that the tax rates used for real-world financial decision making are current.

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CHAPTER SUPPLEMENT

1

FORMS OF BUSINESS ORGANIZATION, OWNERSHIP, AND STRUCTURE

Supplement Learning Objectives

After studying this chapter supplement, readers should be able to

- describe the basic forms of business organization along with their advantages and disadvantages, and
- discuss the two basic types of ownership and explain why ownership type is important when making financial management decisions.

Forms of Business Organization

There are four primary forms of *business organization*: (1) proprietorship, (2) partnership, (3) corporation, and (4) hybrid. Most healthcare managers work for corporations and because not-for-profit businesses are organized as corporations, this supplement emphasizes this form. However, many individual physician practices are organized as proprietorships, and partnerships are common in group practices and joint ventures. In addition, hybrids are becoming more prevalent among physician practices. Healthcare managers must be familiar with all forms of business organization.

Proprietorship

A *proprietorship*—sometimes called a *sole proprietorship*—is a business owned by one individual. Going into business as a proprietor is easy: The owner merely begins business operations. However, most cities require even the smallest businesses to be licensed, and state licensure is required of most healthcare professionals.

The proprietorship form of organization is easily and inexpensively formed, is subject to few governmental regulations, and pays no corporate income taxes. All earnings of the business—whether reinvested in the business or withdrawn by the owner—are taxed as personal income to the proprietor. In general, sole proprietorships pay lower total taxes than comparable, taxable corporations do because corporate profits are taxed twice—once at

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the corporate level and once by stockholders at the personal level when profits are distributed as dividends or when capital gains are realized.

Partnership

A *partnership* is formed when two or more individuals associate to conduct a nonincorporated business. Partnerships operate under different degrees of formality, ranging from informal, verbal understandings to formal agreements filed with the state in which the partnership does business. Like proprietorships, partnerships are inexpensive and easy to form. In addition, the tax treatment of partnerships is similar to that of proprietorships; a partnership's earnings are allocated to the partners and taxed as personal income regardless of whether the earnings are paid out to the partners or retained in the business.[1]

Proprietorships and partnerships have three important limitations:

1. It is usually difficult for owners to sell or transfer their interest in the business.
2. The owners have unlimited personal liability for the debts of the business, which can result in losses greater than the amount invested in the business. In a proprietorship, *unlimited liability* means that the owner is personally responsible for the debts of the business. In a partnership, it means that if any partner is unable to meet his pro rata obligation in the event of bankruptcy, the remaining partners are responsible for the unsatisfied claims and must draw on their personal assets if necessary.
3. The life of the business is limited to the life of the owners.

From a finance perspective, these three disadvantages—difficulty in transferring ownership, unlimited liability, and impermanence of the business—lead to a fourth major disadvantage: It is difficult for proprietors and partners to attract substantial amounts of capital (raise money for the business). This difficulty is not a particular problem for a slow-growing business or when the owners are wealthy, but for most businesses, it becomes a handicap if the business needs to expand rapidly to take advantage of market opportunities. For this reason, proprietorships and most partnerships are small businesses.[2] However, almost all businesses start as sole proprietorships, partnerships, or hybrids and then convert to the corporate form if large amounts of capital are needed.

Corporation

A *corporation* is a legal entity that is separate and distinct from its owners and managers. Although corporations can be investor owned or not-for-profit,

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this section focuses on investor-owned corporations. The unique features of not-for-profit corporations are discussed in later sections. The creation of a separate business entity gives the corporation three main advantages:

1. A corporation has an unlimited lifespan and can continue in existence after its original owners and managers have died or left the firm.
2. It is easy to transfer ownership in a corporation because ownership is divided into shares of stock that can be easily sold.
3. Owners of a corporation have limited liability.

To gain an understanding of *limited liability*, suppose that one person made an investment of $10,000 in a partnership that subsequently went bankrupt and owed $100,000. Because the partners are liable for the debts of the partnership, that partner can be assessed a share of the partnership's debt in addition to the initial $10,000 contribution. If the other partners are unable to pay their shares of the debt, one partner would be held liable for the entire $100,000. If the $10,000 had been invested in a corporation that went bankrupt, the loss for the investor would be limited to the initial $10,000 investment. (In the case of small, financially weak corporations, the limited liability feature of ownership is often fictitious because bankers and other lenders require personal guarantees from the stockholders.) With these three factors—unlimited life, ease of ownership transfer, and limited liability—corporations can more easily raise money in the financial markets than sole proprietorships or partnerships can.[3]

The corporate form of organization has two primary disadvantages. First, corporate earnings of taxable entities are subject to double taxation—once at the corporate level and once at the personal level, when dividends are paid to stockholders or capital gains are realized. Second, setting up a corporation, and then filing the required periodic state and federal reports, is more costly and time-consuming than establishing a proprietorship or partnership.

Although a proprietorship or partnership can begin operations without much legal paperwork, setting up a corporation requires that the founders, or their attorney, prepare a charter and a set of bylaws. Today, attorneys have standard forms for charters and bylaws, so they can set up a no-frills corporation with much less work than that required to do so in the past. In addition, required forms are available online so that founders can do the work themselves. Still, setting up a corporation remains relatively difficult when compared to setting up a proprietorship or partnership, and it is even more difficult if the corporation has nonstandard features.

The *charter* includes the name of the corporation, its proposed activities, the amount of stock to be issued (if investor owned), and the number and names of the initial set of directors. The charter is filed with the

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appropriate official of the state in which the business will be incorporated. When the charter is approved, the corporation officially exists.[4] After the corporation has been officially formed, it must file quarterly and annual financial and tax reports with state and federal agencies.

Bylaws are a set of rules drawn up by the founders to provide guidance for the governing and internal management of the corporation. Bylaws include information about how directors are to be elected, whether the existing shareholders have the first right to buy new shares that the firm issues, and the procedures for changing the charter or bylaws.

For the following three reasons, the value of any investor-owned business, other than a very small one, generally is maximized if it is organized as a corporation:

1. Limited liability reduces the risks borne by equity investors (the owners); in general, the lower the risk, the higher the value of the investment.
2. A business's value is dependent on growth opportunities, which in turn are dependent on the business's ability to attract capital. Because corporations can obtain capital more easily than other forms of business can, they are better able to take advantage of growth opportunities.
3. The value of any investment is affected by its *liquidity*, which means the ease with which the investment can be sold for a fair price. Because an equity investment in a corporation is much more liquid than a similar investment in a proprietorship or partnership, the corporate form of organization creates more value for its owners.

Hybrid

Although the three traditional forms of organization—proprietorship, partnership, and corporation—dominated the business scene for decades, businesses are now using several hybrids. Several of these forms have become popular in the health services industry.

There are specialized types of partnerships that have characteristics somewhat different from those of a standard partnership. For example, in a *limited partnership*, certain partners are designated *general partners* and others *limited partners*. The limited partners, like the owners of a corporation, are liable only for the amount of their investment in the partnership, while the general partners have unlimited liability. However, the limited partners typically have no control; it rests solely with the general partners. Limited partnerships are common in real estate and mineral investments. They are not as common in the health services industry because in this setting it is difficult to find one partner who is willing to accept all of the business's risk and a second partner who is willing to relinquish all control.

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The *limited liability partnership (LLP)* is a type of partnership in which the partners have joint liability for all actions of the partnership, including personal injuries and indebtedness. However, all partners enjoy limited liability regarding professional malpractice because they are liable only for their own malpractice actions, not those of the other partners. In spite of limited malpractice liability, the partners are jointly liable for the partnership's debts. Menomonee Falls Ambulatory Surgery Center in Wisconsin is an example of an LLP (www.mfasc.com).

The *limited liability company (LLC)* is another type of hybrid business organization. It has some characteristics of a partnership and a corporation. The owners of an LLC are called *members*, and they are taxed as if they were partners in a partnership. However, a member's liability is like that of a stockholder of a corporation because liability is limited to the member's initial contribution in the business. Personal assets are at risk only if the member assumes specific liability—for example, the member signs a personal loan guarantee. Ardent Health Services (www.ardenthealth.com), an organization with 12 acute care hospitals, a health plan, and almost 12,000 employees, is an example of an LLC. The LLP and LLC are complex types of hybrid organization, so setting them up can be time-consuming and costly.

The *professional corporation (PC)*, called a *professional association (PA)* in some states, is a form of organization common among physicians and other individual and group practice healthcare professionals. All 50 states have statutes that prescribe the requirements for such corporations, which provide the usual benefits of incorporation but do not relieve the participants of professional liability. Indeed, the primary motivation behind the PC, which is a relatively old business form compared to the LLP and LLC, was to provide a way for professionals to incorporate yet still be held liable for professional malpractice. PCs have tight restrictions. First, one or more owners must be licensed in the profession of the PC. Second, PCs are taxed as corporations; they cannot be designated as an S corporation for tax purposes (see the following paragraph). Paragon Health PC (www.paragonhealthpc.com), a multispecialty group practice located in southwest Michigan, is an example of a PC.

For tax purposes, standard for-profit corporations are called *C corporations.* If certain requirements are met, either one or a few individuals can incorporate but, for tax purposes only, elect to be treated as if the business were a proprietorship or partnership. Such corporations, which differ only in how the owners are taxed, are called *S corporations.* Although S corporations are similar to LLPs and LLCs regarding taxes, LLPs and LLCs afford owners more flexibility and benefits. For these reasons, many businesses—especially group practices—are converting to these newer forms.

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SELF-TEST QUESTIONS

1. What are the four forms of business organization, and how do they differ?
2. What are some different types of partnerships?
3. What are some different types of corporations?

Alternative Forms of Ownership

Unlike other sectors in the economy, not-for-profit corporations play a major role in the healthcare sector, especially among providers. For example, only 20 percent of nongovernmental hospitals are investor owned; the remaining 80 percent are not-for-profit. Furthermore, not-for-profit ownership is common in the nursing home, home health care, and managed care industries.

Investor-Owned Corporations

As discussed in the previous section, for-profit businesses can be organized in a variety of ways. However, because of their size, corporations are the largest employers of healthcare professionals. When the average person thinks of a corporation, she probably thinks of an investor-owned, or for-profit, corporation. Virtually all large businesses (e.g., Ford, Microsoft, IBM, General Electric) are investor-owned corporations.

Investors become owners of such businesses by buying shares of *common stock* in the firm. Investors may buy common stock when it is first sold by the firm. Such sales are called *primary market transactions.* In a primary market transaction, the funds raised from the sale generally go to the corporation.[5] After the shares have been initially sold by the corporation, they are traded in the *secondary market.* These sales may take place on exchanges, such as the New York Stock Exchange and the American Stock Exchange. They may also take place in the *over-the-counter market*, which is composed of a large number of dealers/brokers connected by a sophisticated electronic trading system. When shares are bought and sold in the secondary market, the corporations whose stocks are traded receive no funds from the trades; corporations receive funds only when shares are first sold to investors.

Investor-owned corporations may be publicly or privately held. The shares of publicly held firms are owned by a large number of investors and are widely traded. For example, Tenet Healthcare (www.tenethealth.com), which operates about 50 hospitals and has more than 480 million shares outstanding, is owned by approximately 50,000 individual and institutional stockholders. Drug manufacturers, such as Merck and Pfizer; medical equipment manufacturers, such as St. Jude Medical, which makes heart valves; and U.S. Surgical, which makes surgical stapling instruments, are all publicly held corporations.

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Conversely, the shares of *privately held*, also called *closely held*, firms are owned by just a handful of investors or by a private business that owns other businesses and are not publicly traded. In general, the managers of privately held firms are major stockholders. In terms of ownership and control, therefore, privately held firms are more similar to partnerships than to publicly held firms. Often, the privately held corporation is a transitional form of organization that exists for a short time before a proprietorship or partnership becomes a publicly owned corporation, motivated to go public by capital needs. Wellsprings Healthcare, a Texas firm that helps employers control healthcare costs, is an example of a closely held firm in the health services industry. Another example is HCR Manor Care (www.hcr-manorcare.com), which owns and operates more than 500 skilled nursing and rehabilitation centers and assisted living facilities and is owned by the Carlyle Group, a private investment firm.

Stockholders, also called *shareholders*, are the owners of investor-owned firms. As owners, they have three basic rights:

1. **The right of control**. Common stockholders have the right to vote for the corporation's board of directors, which oversees the management of the firm. Each year, a firm's stockholders receive a *proxy* ballot, which they use to vote for directors and vote on other issues proposed by management or stockholders. In this way, stockholders exercise control. In the voting process, stockholders cast one vote for each common share held.
2. **A claim on the residual earnings of the firm**. A corporation sells products or services and realizes revenues from the sales. To produce these revenues, the corporation must incur expenses for materials, labor, insurance, debt capital, and so on. Any excess of revenues over expenses—the residual earnings—belongs to the shareholders of the business. Often, a portion of these earnings are paid out in the form of *dividends*, which are cash payments to stockholders, or *stock repurchases*, in which the firm buys back shares held by stockholders. However, management typically elects to reinvest some or all of the residual earnings in the business, which presumably will produce even higher payouts to stockholders in the future.
3. **A claim on liquidation proceeds**. In the event of bankruptcy and liquidation, shareholders are entitled to any proceeds that remain after all other claimants have been satisfied.

In summary, there are three key features of investor-owned corporations. First, the owners (the stockholders) of the business are well defined and exercise control of the firm by voting for directors. Second, the residual

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earnings of the business belong to the owners, so management is responsible only to the stockholders for the profitability of the firm. Third, investor-owned corporations are subject to taxation at the local, state, and federal levels.

Not-for-Profit Corporations

If an organization meets a set of stringent requirements, it can qualify for incorporation as a *tax-exempt*, or *not-for-profit, corporation*. Tax-exempt corporations are sometimes called *nonprofit corporations*. Because nonprofit **businesses** (as opposed to pure charities) need profits to sustain operations, and because it is hard to explain why nonprofit corporations should earn profits, the term *not-for-profit* is more descriptive of nonprofit health services corporations.

Tax-exempt status is granted to businesses that meet the tax definition of a charitable corporation, as defined by Internal Revenue Service (IRS) Tax Code Section 501(c)(3) or (4). Hence, such corporations are also known as *501(c)(3) or (4) corporations*. The tax code defines a charitable organization as "any corporation, community chest, fund, or foundation that is organized and operated exclusively for religious, charitable, scientific, public safety, literary, or educational purposes." Because the promotion of health is commonly considered a charitable activity, a corporation that provides healthcare services can qualify for tax-exempt status, provided it meets other requirements.[6]

In addition to having a charitable purpose, a not-for-profit corporation must operate exclusively for the public, rather than private, interest. Thus, no profits can be used for private gain and no political activity can be conducted. Also, if the corporation is liquidated or sold to an investor-owned firm, the proceeds from the liquidation or sale must be used for a charitable purpose. Because individuals cannot benefit from the profits of not-for-profit corporations, such organizations cannot pay dividends. However, prohibition of private gain from profits does not prevent parties of not-for-profit corporations, such as managers and physicians, from benefiting through salaries, perquisites, contracts, and so on.

Not-for-profit corporations differ significantly from investor-owned corporations. Because not-for-profit firms have no shareholders, no single body of individuals has ownership rights to the firm's residual earnings or exercises control of the firm. Rather, control is exercised by a board of trustees, which is not constrained by outside oversight. Also, not-for-profit corporations are generally exempt from taxation, including both property and income taxes, and have the right to issue tax-exempt debt (municipal bonds). Finally, individual contributions to not-for-profit organizations can be deducted from taxable income by the donor, so not-for-profit firms have access to tax-subsidized contribution capital. (The tax benefits enjoyed by not-for-profit corporations are reviewed in the previous section on tax laws.)

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The financial problems facing most federal, state, and local governments have caused politicians to take a closer look at the tax subsidies provided to not-for-profit hospitals. For example, several bills have been introduced in Congress that require hospitals to provide minimum levels of care to the indigent to retain tax-exempt status. Such efforts by Congress prompted the American Hospital Association in 2007 to publish guidelines for charity care that include (1) giving discounts to uninsured patients of "limited means"; (2) establishing a common definition of "community benefits," which encompass the full range of services provided to the population served; and (3) improving "transparency," or the ability of outsiders to understand a business's governance structure and policies, including executive compensation. Starting with tax year 2009, Schedule H of the revised Form 990 requires that hospitals collect and analyze additional data regarding their community benefit activities and the charity care they provide, and determine the value of both according to standards adopted by the IRS.

Likewise, officials in several states have proposed legislation that mandates the amount of charity care provided by not-for-profit hospitals and the billing and collections procedures applied to the uninsured. For example, Texas has established minimum requirements for charity care, which hold not-for-profit hospitals accountable to the public for the tax exemptions they receive. The Texas law specifies four tests, and each hospital must meet at least one of them. The test that most hospitals use to comply with the law requires that at least 4 percent of net patient service revenue be spent on charity care. Ohio legislators have held hearings to discuss whether a law should be passed requiring Ohio's not-for-profit hospitals to make "Payments in Lieu of Taxes" (PILOTs).

Finally, money-starved municipalities in several states have attacked the property tax exemption of not-for-profit hospitals that have "neglected" their charitable missions. For example, tax assessors are fighting to remove property tax exemptions from not-for-profit hospitals in several Pennsylvania cities after an appellate court ruling supported the Erie school district's authority to tax a local hospital that had strayed too far from its charitable purpose. According to one estimate, if all not-for-profit hospitals had to pay taxes comparable to those their investor-owned counterparts pay, local, state, and federal governments would garner an additional $3.5 billion in tax revenues. This estimate explains why tax authorities in many jurisdictions are pursuing not-for-profit hospitals as a source of revenue.

The inherent differences between investor-owned and not-for-profit organizations have profound implications for many elements of healthcare financial management, including organizational goals, financing decisions (i.e., the choice between debt and equity financing and the types of securities issued), and capital investment decisions. Ownership's effect on the

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application of healthcare financial management theory and concepts is addressed throughout the text.

SELF-TEST QUESTIONS

1. What are the major differences between investor-owned and not-for-profit corporations?
2. What pressures have been placed on not-for-profit hospitals to ensure that they meet their charitable mission?

Organizational Structures

Whether investor owned or not-for-profit, health services organizations can be structured in an almost unlimited number of ways. At the most basic level, a healthcare provider can be a single entity with one operating unit. In this situation, all of the financial management decisions for the organization are made by a single set of managers. Alternatively, corporations can be set up with separate operating divisions or as holding companies with wholly or partially owned subsidiary corporations in which different management layers have different financial management responsibilities.

Holding Companies

Today, many organizations—both investor owned and not-for-profit—have adopted *holding company* structures to take advantage of economies of scale, or scope, in operations and financing or to gain favorable legal or tax treatment. Holding companies date from 1889, when New Jersey became the first state to pass a law permitting corporations to be formed for the sole purpose of owning the stocks of other firms. Many of the advantages and disadvantages of holding companies are identical to those inherent in a large firm with several divisions. Whether a firm is organized on a divisional basis or as a holding company with several subsidiary corporations does not affect the basic reasons for conducting large-scale, multiproduct or multiservice, multifacility operations. However, the holding company structure has some distinct advantages and disadvantages when compared with the divisional structure.

There are several advantages to holding companies:

- **Control with fractional ownership**. A holding company may buy a fraction of the stock of another corporation, say 5, 10, or 50 percent. Such fractional ownership may be sufficient in giving the acquiring firm effective working control, or at least substantial influence, over the operations of the firm in which it has acquired stock ownership.

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Working control is often considered to entail more than 25 percent of the common stock, but it can be as low as 10 percent if the stock is widely held.

- **Isolation of risks**. Because the various operating firms in a holding company system are separate legal entities, the obligations of one unit are separate from those of the other units. Therefore, catastrophic losses incurred by one unit of the system are not transferable into claims against the other units. This separation can be especially beneficial when the operating units carry the potential for large losses from malpractice or other liability lawsuits. Note, though, that the parent firm often voluntarily steps in to aid a subsidiary with large losses, either to protect the good name of the firm or to protect its investment in the subsidiary.
- **Separation of for-profit and not-for-profit subsidiaries**. Holding company organization facilitates expansion into both tax-exempt and taxable activities well beyond patient care. However, a tax-exempt holding company must ensure that all transactions with the taxable subsidiaries are conducted at arm's length, otherwise the tax-exempt status of the parent holding company can be challenged. Investor-owned multihospital systems are organized similarly, except all of the entities are taxable, for-profit organizations. Note that although not-for-profit holding companies are allowed to have taxable subsidiaries, for-profit holding companies are **not** permitted to own tax-exempt subsidiaries.

Holding companies have the following disadvantages:

- **Partial multiple taxation**. Investor-owned holding companies that own at least 80 percent of a subsidiary's common stock can file a consolidated return for federal income tax purposes. In effect, the holding company and the subsidiary are treated as a single entity; all of their revenues and costs are aggregated. However, when less than 80 percent of the stock is owned, the only way that the subsidiary can transfer funds to the holding company is by paying dividends, and such dividends face partial multiple taxation. For example, holding companies that own more than 20 percent but less than 80 percent of the stock of another corporation must pay tax on 20 percent of the dividends received (80 percent are nontaxable), and companies that own less than 20 percent must pay tax on 30 percent of the dividends (70 percent are nontaxable). Because the subsidiary must pay taxes on the earnings prior to making the dividend payment, the funds transferred to the parent are taxed twice.

Chapter 1 Supplement

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- **Ease of forced divestiture**. In the event of antitrust action, a holding company can easily relinquish ownership in a subsidiary by selling the stock to another party. This ease of transfer is considered a disadvantage because it increases the likelihood that government agencies will demand divestiture if antitrust concerns arise.

Multihospital Systems

Multihospital systems, including tax-exempt and for-profit organizations, have grown much faster than freestanding hospitals over the past 30 years. Several advantages of multihospital systems have been hypothesized, including the following:

- Better access to capital markets, which results in lower capital costs
- Elimination of duplicate services, which increases the volume of services at the remaining sites and results in lower unit costs and increased quality
- Economies of scale
- Access to specialized managerial skills within the system
- Ability to recruit and retain better personnel because of superior training programs, advancement opportunities, and transfer opportunities
- Increased political power in dealing with governmental issues such as property taxes, certificates of need, and government reimbursement systems
- Increased bargaining power with payers

In recent years, the largest systems have tended to shed some hospitals, although there continues to be some consolidation within local markets. Hospital systems appear to have more economies of scale within local markets than they do regionally or nationally. However, large healthcare systems have also faced increased scrutiny as critics question whether their group bargaining power stifles competition. For example, Partners HealthCare System, which includes two large academic medical centers and 11 community hospitals and outpatient facilities, was the subject of a spotlight series in the *Boston Globe* that accused the organization and its pricing strategies for the increase in the cost of care in Massachusetts.

Corporate Alliances

Corporate alliances can provide some of the benefits of multi-institutional systems without requiring common ownership. Industry trade groups, which tend to operate at both state and national levels, are the least binding type of corporate alliance. For example, the American Hospital Association and

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its state organizations—such as the Florida Hospital Association—constitute one major hospital trade association. Also, the American Association of Equipment Lessors is the trade group for firms that lease equipment to the health services industry.

Other types of alliances can be more binding but provide more benefits to their members. For example, several hospital alliances exist primarily to give their members purchasing clout. One of the largest of such alliances is VHA (formerly Voluntary Hospitals of America), a for-profit firm whose shareholders are its member hospitals, all not-for-profit institutions, and their physicians. VHA's firms and subsidiaries provide members and affiliates with management services in such areas as procurement, data management, marketing, and even capital acquisition. VHA's members and affiliates retain local control and autonomy yet gain many of the advantages of a large system.

In addition to alliances among similar organizations, alliances are also being formed among dissimilar providers to offer a more complete range of services. Such vertical alliances are discussed in the next section.

Integrated Delivery Systems

The most dynamic recent changes to organizational structures in health services have centered on the *integrated delivery system*.[7] In the 1970s, horizontal integration, such as the combining of hospitals, was the dominant trend in organizational evolution. In the 1980s and well into the 1990s, the dominant organizational movement was toward vertically integrated systems. In an integrated delivery system, a single organization (or a closely aligned group of organizations), offers a broad range of patient care and support services operated in a unified manner. The range of services offered by an integrated delivery system may focus on a particular area, such as long-term care or mental health; more commonly, it may offer comprehensive subacute, acute, and postacute services.

An integrated delivery system may have a single owner, or it may have multiple owners joined together by contracts and agreements. The driving force behind these systems is the motivation to offer a full line of coordinated services and hence to increase the overall effectiveness and lower the overall cost of the services provided. Costs are reduced by providing only necessary services and ensuring that the services are provided at the most cost-effective clinical level. Integrated delivery systems may be formed by managed care plans or even directly by employers, but more often they are formed by providers to facilitate contracting with plans or employers.

The key feature of integrated delivery systems is that, to be successful, the primary focus must be the clinical effectiveness and profitability of the system as a whole, as opposed to each individual element. This emphasis requires a much higher level of administrative and clinical integration than is seen in most organizations; more important, it requires that managers of the

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system's individual elements place their own interests second to those of the overall system. In addition, it requires a management information system that seamlessly passes managerial and patient data among all of the components of the integrated system. Although single-owner systems appear to have advantages over systems that are contractually created, such advantages, if they do exist, have proven to be difficult to realize in practice. The emphasis now appears to be on creating smaller, more focused businesses that are easier to manage. However, the integration of hospitals and physicians appears to be gaining momentum in response to healthcare reform and implementation measures that reward hospital–physician cooperation.

SELF-TEST QUESTIONS

1. What are the advantages and disadvantages of the holding company form of organization?
2. What is the difference between horizontal and vertical integration?
3. What are integrated delivery systems, how are they created, and what is the driving force behind them? What challenges do integrated delivery systems face?

Supplement Key Concepts

This chapter supplement presents some background information on forms of business organization and alternative forms of ownership. Here are its key concepts:

- The four forms of business organization are *sole proprietorship*, *partnership*, *corporation*, and *hybrid*.
- Although each form of organization has unique advantages and disadvantages, most large organizations and all not-for-profit entities are organized as *corporations*.
- *Investor-owned corporations* have *shareholders* who are the owners of the firm. Shareholders exercise control through the *proxy* process by electing the firm's board of directors and voting on matters of major consequence to the firm. As owners, the shareholders have a claim on the residual earnings of the firm. Investor-owned firms are fully taxable.
- Organizations that serve a charitable purpose and meet certain criteria can be organized as *not-for-profit corporations*. Rather than have a well-defined set of owners, such organizations have a large

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number of *stakeholders* who have an interest in the organization. Not-for-profit firms do not pay taxes, can accept tax-deductible contributions, and can issue tax-exempt (municipal) debt.

The various forms of business organization influence both healthcare operations and financial management and have an impact on organizational goals. Chapter 1 discusses organizational goals and the implications on for-profit and not-for-profit healthcare corporations.

Supplement Bibliography

Greener, B. 2007. "Finding the Right Structure for Your Business." *Optics and Photonics News* 18 (5): 12.

Schneeman, A. 1997. *The Law of Corporations, Partnerships, and Sole Proprietorships.* Albany, NY: Delmar Publishers.

Supplement Websites

The following websites pertain to the content of this chapter:

- For more information on forms of business organization, go to http://bls.dor.wa.gov/index.aspx.
- For information on the various forms of corporations, go to www.sos.wa.gov/corps/.

Supplement Notes

1. Note that a tax-exempt corporation can be one partner of a partnership. In this situation, profits allocated to the tax-exempt partner are not taxed, but those allocated to taxable partners are subject to taxation.
2. Although most partnerships are small, some large firms are organized as partnerships or as hybrid organizations. Examples include major public accounting firms and many large law firms.
3. *Financial markets* bring together individuals and businesses that need money with other individuals and businesses that have excess funds to invest. In a developed economy, such as in the United States, there are many financial markets. Some markets deal with debt capital, while

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others deal with equity capital; some deal with short-term capital, and others deal with long-term capital; and so on. The ways in which financial markets operate and their benefits to healthcare businesses are discussed throughout the text.

4. More than 60 percent of corporations in the United States are chartered in Delaware, which over the years has provided a favorable governmental and legal environment for business activities. A firm does not have to be headquartered or even conduct business in its state of incorporation.
5. In rare situations, shares can be sold to the public for the first time by the corporation's original owners or by a foundation established by the owners, rather than directly by the firm. In such situations, the proceeds from the sale go to the original owners or foundation and not to the firm. Stock sales are discussed in more detail in Chapter 7.
6. An entire chapter can easily be filled with the details of obtaining and maintaining tax-exempt status, but our focus is on the impact of such status on financial management decision making.
7. For a thorough discussion of integrated delivery systems, see Lega, F. 2007. "Organizational Design for Health Integrated Delivery Systems: Theory and Practice." *Health Policy* 81 (2–3): 258–79.

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