

Michigan Great Lakes HFMA

CHFP Exam Prep Session #3

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Jason Roher
Supervisor, Reimbursement
Sparrow Health System





Certified Healthcare Financial Professional

Module I - The Business of Healthcare

Course 3: Cost Analysis Principles

Learning Objectives

- Define the term “cost” for healthcare services
- Differentiate the ways cost can be determined for healthcare services
- Identify various methods for cost-allocation in healthcare organizations
- Determine how costs are used to identify prices in healthcare organizations

Polling Question 1

Lakeside Clinic is planning to renovate its existing building that will decrease the amount of square footage in its pediatric exam rooms by 500 square feet and increase the space in the billing office by 500 square feet. Lakeside Clinic allocates its housekeeping costs to revenue producing departments based on square footage. How will this change affect the allocation of housekeeping costs to the pediatric area?

Select the Best Response

- A. The housekeeping allocation per square foot increases.
- B. The amount allocated to pediatrics decreases.
- C. The allocation amount stays the same.
- D. The amount allocated to pediatrics increases.

What Comes to Mind...



COST

Cost can be the amount paid for a service. It also can be the amount paid for salaries or to a vendor

Cost Management for Healthcare Providers vs Health Insurers

- Cost Management impacts both Providers and Insurers
- Healthcare Cost even affects employers/employees

High cost physician offices and hospitals → higher insurance premiums → higher employee benefits costs → loss of business to competitors

Types of Cost

- Direct
- Indirect
- Variable
- Fixed

Examples of Costs

Direct costs are those that are incurred to provide services directly to patients, while indirect costs are those necessary to operate the facility. The costs are placed in the appropriate columns below.

Direct Costs

Medicine

Nurse salary

X-ray

Indirect Costs

Electric

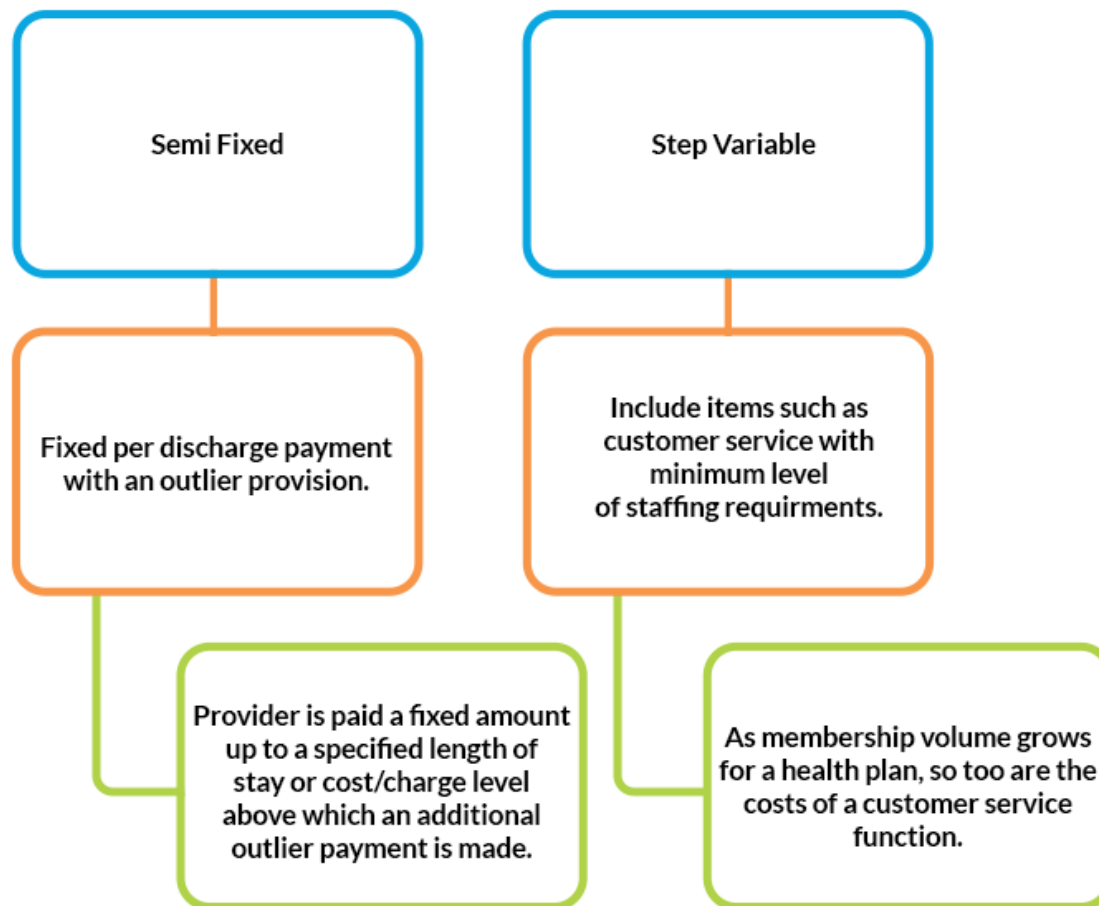
IT support

Janitorial service

Types of Cost

- Semi-fixed
- Step Variable
- Short –term
- Long-term

Example of Semi Fixed Vs Step Variable



Polling Question 2

- What current position do you hold in your company?
 - A. Manager/Director at a Provider
 - B. Professional Staff at a Provider
 - C. Executive/C-Suite at Provider/Vendor
 - D. I work for a Vendor

Cost Allocation

The challenge:

What is the actual cost of providing service to a patient?



Cost Allocation

- Cost Pool
- Costs Driver

DEPARTMENT	COST DRIVER
Administration	Number of employees or total revenues
Accounting	Number of employees or total revenues
Housekeeping	Square footage cleaned
Maintenance	Square footage maintained or work orders completed
Information Systems	Number of users
Human Resources	Number of employees

Cost Allocation

- Revenue Producing Departments
- Non-revenue (or overhead) Departments

Cost Allocation

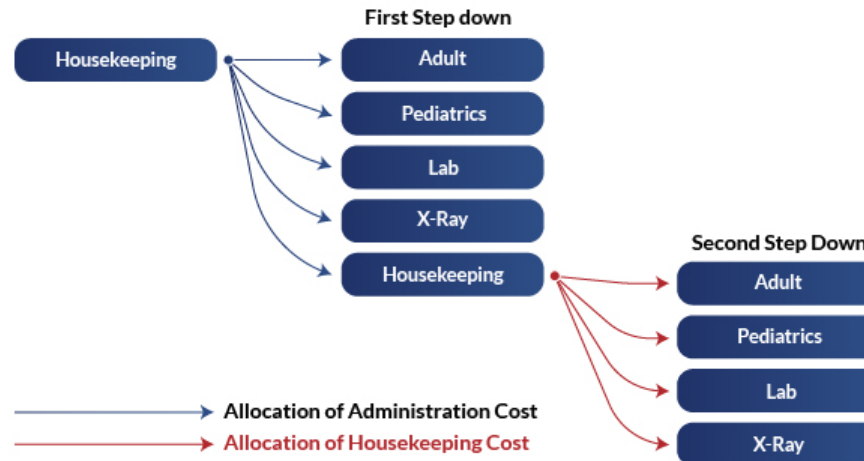
- Example of a Hospital Cost Allocation

Suppose we have a 6,000 square foot building but only 5,000 square feet of the building is utilized for patient care. The other 1,000 square feet is administrative space.

DEPARTMENT	SQUARE FEET	% OF SQUARE FEET	ALLOCATED COSTS
Adult Medicine	1,500	30%	\$7,500
Pediatrics	1,500	30%	\$7,500
Laboratory	750	15%	\$3,750
X-Rays	1,250	25%	\$6,250
Total	5,000	100%	\$25,000

Cost Allocation

- Example of the Step-down Approach



Cost Allocation

- Activity Based Costing (ABC)
 - Two steps:
 - gathering total data and activity statistics
 - then allocating the costs of activities to a service.

Cost Allocation

- Illustration of Cost Allocation in the Activity Based Costing Method

ACTIVITY	ANNUAL COSTS	COST DRIVER	ACTIVITY TOTAL			ALLOCATION RATE
			MEDICINE	BEHAVIORAL HEALTH	TOTAL	
REGISTRATION & CHECK-OUT	25,000	# Visits	4,000	1,000	5,000	\$5 / Visit
VITAL SIGNS	50,000	Minutes / Visit	10	5	50,000	\$1 / Minute
DIAGNOSIS	300,000	Minutes / Visit	10	20	60,000	\$5 / Minute
TREATMENT	320,000	Minutes / Visit	15	20	80,000	\$4 / Minute
MEDICATIONS	75,000	Medications / Visit	1	1	7,500	\$10 / Medication
BILLING	200,000	# Visits	4,000	1,000	5,000	\$40 / Visit
TOTAL	970,000					

Setting Prices

- Full Cost Pricing

Little competition = full-cost pricing =
direct and overhead costs + desired profit

- Marginal Cost Pricing

More competition may call for pricing
below full cost to attract or retain volume.

Polling Question 3

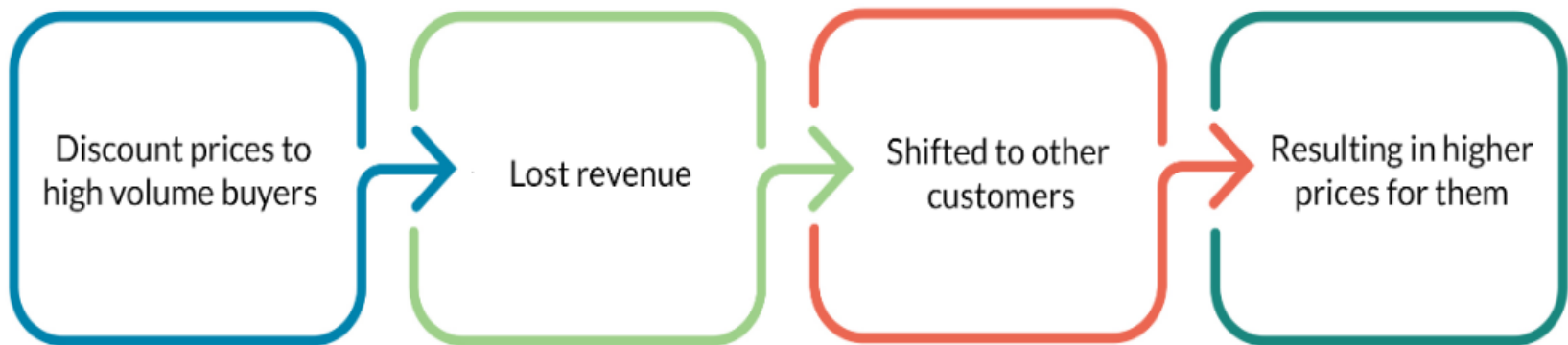
A manager using marginal cost pricing is unable to realize a profit. Which of the methods below will enable him to resolve this issue?

Select the best response.

- A. Forgo making a profit
- B. Reduce indirect costs
- C. Shift costs to other customers
- D. Increase volume

Cost Shifting

- Marginal Cost Pricing Approach



Contribution Margin

Contribution margin =
revenue - variable cost

or

Contribution margin per unit =
price - variable cost per unit

Target Cost Pricing

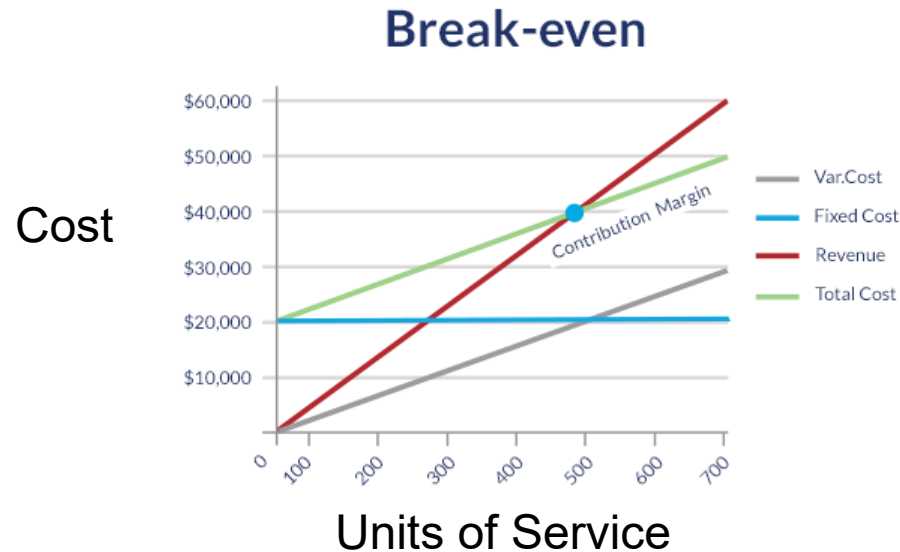


Health Plans Target Cost Pricing

- Community Rate Setting
- Group (Experienced Rate Setting)



Break Even Analysis



Contribution margin = premiums - medical expenses

This amount is applied against fixed costs to determine the break-even point

Summary

Don't allow fees to decrease so much as to limit the number of providers available



Polling Question 4

- Regarding Full Cost Pricing and Marginal Cost Pricing, which statement below is true? (Select the best response)
 - A. Full cost pricing includes all direct and overhead costs plus a desired level of profit and is used when competition is low
 - B. Marginal cost pricing includes all direct and overhead costs plus a desired level of profit and is used when competition is low
 - C. Full cost pricing includes all direct and overhead costs plus a desired level of profit and is used when competition is high
 - D. I'm not sure I wasn't paying attention!



Questions?

Supplemental Questions

- The price set by a hospital or physician for their services is:
 - a) An estimate of cost absent full loaded fees
 - b) A “charge”
 - c) A retail price that is negotiable
 - d) The amount the insurer can be expected to reimburse

Supplemental Questions

The practice of making the assumption that some customers will be profitable and others may not – but in the aggregate a price offered to all buyers will be profitable is known as:

- a) Aggregate pricing
- b) Loss mitigation pricing
- c) Risk absorption pricing
- d) Target cost pricing

Supplemental Questions

A marginal cost pricing approach requires:

- a) Willingness to adjust margin expectations depending on market response to prices
- b) Determining how much cost to include in pricing
- c) Clearly establishing the minimal cost that a unit of service can be provided
- d) Deciding on an acceptable level of ROI on a unit of service

Supplemental Questions

Under a full-cost pricing approach, the price for services:

- a) Is set to be commensurate with competition prices for a similar service
- b) Must be established to cover all costs for providing the service
- c) Is established to cover all costs for offering the service plus a desired margin
- d) Is built with consideration of the market's price sensitivity for out-of-pocket payment amounts