Resource Guide

Health Care Contracting Financial Acumen Glossary

Average cost: Calculated by dividing total cost by volume. Average total cost is equivalent to average variable plus average fixed cost.

Barriers to Entry: Obstacles to overcome or higher costs that the potential entrants must incur to enter a market if they are to compete successfully in the industry.

Breakeven: The volume of activity such that the net income resulting from it is zero—costs are equal to revenues).

Business Case: The justification of an investment based solely on the positive financial consequences for the entity making the investment.

Capitation: A payment model in which a health plan or provider receives an agreed-upon per member per month fee and is obligated to provide stipulated medical services regardless of volume or costs.

Cash Reserves: Funds that an entity sets aside for use in emergencies.

Contribution: The difference between the revenues taken in and the variable expenses incurred.

Cost-Benefit Analysis: A form of economic evaluation in which the program consequences are valued in monetary terms to compare them with the program cost.

Cost-Effectiveness Analysis: A form of economic evaluation in which two or more interventions are compared using identical consequences, which are then compared to their relative costs.

Cost-Based Price: Method in which the price set by a community-based organization (CBO) is based strictly on its own costs.

Cost-Informed Price: Method in which the price set by a CBO is based partly on its costs but takes into account of other factors such as the value of its service to the client.

Cost-Utility Analysis: A form of economic evaluation in which the program consequences are assessed to reflect both the enhanced quality of life and the added length of life of the person receiving services. These measures are collapsed into a single measure called "quality-adjusted life years" and then compared with the cost of bringing about this outcome.

Difference in Differences: An evaluation technique using observational study data that isolates the differential effect of a service or treatment on a treatment group versus a control group. Designed to eliminate biases in measuring impact.

Discounting: A process of determining the present value of a stream of benefits from an investment that accrues in the future. Given the time value of money, a dollar is worth more today than a deferred dollar—given its capacity to earn interest.

Diminishing Marginal Returns: A common phenomenon where the marginal benefit from an activity falls as a function of its volume. The total benefit rises as more of the activity is undertaken, but it rises at a diminishing rate.

Diminishing Marginal Effectiveness: This means that as more of one intervention or input is employed, its effectiveness on the margin declines, possibly because individuals differ in their responsiveness to the intervention.

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Economic Burden: The financial consequences of a medical or health condition, harm or disease. Interventions are intended to reduce costs associated with poor condition or circumstances, ameliorating the economic burden of having such a condition.

Economies of Scale: The phenomenon of average cost falling as volume rises. These economies almost always stem from the existence of fixed expenses.

Economies of Scope: Economies of scope occur when producing a wider variety of services at once is more cost-effective for a CBO than producing a smaller variety or producing each service independently.

Dominant Technology: A term used in cost-effectiveness analysis in which intervention is superior on cost and effectiveness criteria and therefore is the preferred technology.

Externalities: When the action, choice, or behavior of an individual decision-maker impacts the well-being of others. Externalities are consequences of decisions (costs and benefits) incurred or enjoyed by parties other than the one making the decision.

External Cost (Benefit): A cost (benefit) borne by someone other than the decision-maker.

Financial Acumen: The ability to use an array of financial tools, concepts and language to make decisions.

Fixed Cost: A cost that remains the same regardless of the volume of an activity. A fixed cost is irrelevant in decisions involving the appropriate choice of volume.

Gain Sharing: A reimbursement system in which a CBO receives a portion of the financial benefit it confers to a health sector partner as part of its price or fees.

Historical Cost: The original cost at which an asset was purchased, sometimes referred to as acquisition cost.

Hurdle Rate: The minimum return on investment that a project or program must generate to be deemed worthwhile. The hurdle rate reflects the fact that investment dollars can be used in variety of ways

Implicit Cost: The opportunity cost to a resource owner of using that resource.

Indirect Costs: Costs that cannot be easily attributed to a particular a specific service; sometimes used interchangeably with overhead cost.

Incremental Return on Investment (IROI): The return from increasing the amount of an investment. Found by dividing the incremental net benefits by the incremental investment outlay. This metric is used to understand the impact of strategic investments (e.g., adding dollars needed to increase the scale of a program). This calculation enables a comparison between the ROI made during the period in which the infusion of capital was made and the period before without having had that addition.

Incremental Cost-Effectiveness Analysis: A form of economic evaluation in which one intervention is incrementally more effective and incrementally more costly than another. The result of the analysis is a measure of the incremental cost per unit of effect.

Inside-Out Organization: An organization that is narrowly focused on its costs in its price-setting rather than on the value it delivers. Other features include an emphasis on describing service features rather than service benefits and messaging that emphasizes what it does rather than why it does it.

Internal Rate of Return: The discount or interest rate at which the net present value of an investment is equal to zero.

Irrelevant Costs: Costs of other decisions that are not affected by the choice being considered.

Learning Curve: The well-demonstrated and typical effect that cumulated experience has on unit costs of a product or service via a learning effect and resulting in higher productivity.

Loss Leadership: A low-price strategy that results in a loss but consists of the profit from the added demand of complementary services or products that this loss leader generates.

Marginal: The additional or differential amount stemming from taking an activity one step further.

Marginal Cost: The added cost of an additional unit of an activity. For example, the marginal cost of seeing another patient.

Marginal Benefit: The added benefit of an additional unit of an activity. For example, the marginal revenue of seeing another paying patient.

Mutually Exclusive Alternative: When the decision-maker must select either one alternative method or else the other and has no latitude to blend or combine them to achieve optimum results. When a decision-maker is faced with a ROI choice, a larger ROI for one investment relative to another does not mean that it should be the favored investment. If the project with the lesser ROI is of sufficiently larger scale than the other, it may make sense to adopt the one that may have higher net benefits.

Net Operating Income: An organization's revenues minus its operating expenses.

Operating Margin: An organization's net income divided by its revenues.

Outside-In Organization: An organization squarely focused on the market and the customer. Its service price is based on the value it delivers. Other features include describing service benefits rather than service features and messaging that emphasizes not what it does but rather why it does it.

Payback Period: The number of years over which a program must operate in order to recoup its investment. The shorter the payback period, the more attractive the investment.

Opportunity Cost: The value of the highest valued alternative sacrificed as a result of a decision or choice.

Performance-Based Pricing: A pricing strategy in which an organization's price, and therefore its revenues, are partially or wholly dependent on its success in achieving set performance goals and objectives.

Price-Based Costing: A cost-reduction strategy in which a CBO cuts costs to bring them in line with the price at which its service can be sold in a given market.

Principle of Cost Effectiveness: The idea that the preferred method to achieve an objective is the one that has the lower cost per unit of effectiveness.

Quality or Bonus Payments: A special payment available to payees when specific performance goals have been met.

Quality-of-Life-Adjusted Year Saved: A measure of the degree to which medical intervention is effective, expressed in terms of both the resulting longevity and quality of life the patient enjoys. Abbreviated as QALY.

Perspective: Identifying the entity whose costs and benefits will be considered in conducting an economic evaluation. Decisionmakers typically make choices based on their perspective—considering only the benefits they receive and their costs.

Progression from the Mean: The tendency for average values in a probability distribution to become outliers over time. For example, an older adult's medical utilization naturally grows over time from average or normal levels to above normal as they age.

Prospective Fixed Costs: Costs not yet expended that can be avoided but do not vary with future activity volume. These costs should count in future decisions about whether an activity or an investment makes sense. However, prospective fixed costs should not influence scale-related decisions.

Quality Measures: Tools to assess, compare and often reward the quality of care provided by health care entities. Measures are classified as either evaluating structural, process or outcome-oriented results, including direct service recipient satisfaction.

Reversion (or Regression) to the Mean: A tendency for outliers in a probability distribution to attain more normal or average values after the elapsed time. Source of outcome bias in post and pre-utilization comparisons designed to measure program impact. An example is a service offered to a high cost population that even without the service would have, over time, displayed and reverted to a more normal and lower utilization and cost. For example, when considering values measured from people with high blood pressure or blood sugar. They are measured again after providing treatment and found that the mean value of the extreme group (people with high blood pressure or sugar) changes and is closer to the mean of the whole population. This result can make us believe that the treatment is effective. But this can be a case of regression to the mean because even if no treatment is given, the blood pressure or sugar can fall due to various other reasons like measurement error or biological variation and can be for a short duration.

Retrospective Fixed Costs: Costs already expended that cannot be avoided and do not vary with activity volume. This form of cost should not shape future decisions. These are also known as Sunk Costs.

Relevant Cost: A cost incurred as a result of a choice or decision. It is relevant to consider this cost in determining the wisdom of the choice. Sometimes it is referred to as a differential, variable, or incremental cost.

Return on Investment (ROI): The ratio of net benefits (gross benefits minus costs) to costs. The result is a percentage—possibly the most common use of the term ROI. For example, when gross benefits are $100 and costs are $50, net benefits are $50. The ROI is thus 100% ($50/50).

Segmentation Pricing: This occurs when an overall market is divided into segments that differ from one another in terms of price sensitivity. A lower price is offered to the more price-sensitive segment and a higher price to that exhibits less price sensitivity. For example, a CBO may have two distinct partners to which it sells the same service. One partner may be more price sensitive than the other as a result of having more options from which to choose (when there is more competition). To cater to this more price-sensitive segment, the CBO may need to offer a lower price to be competitive and attract the business.

Sensitivity Analysis: This analysis involves experimenting with different values for the key inputs that go into a calculation, such as ROI, to determine how sensitive the result would be to differing assumptions.

Social Case: A demonstration that an initiative's outcomes will generate financial benefits, regardless of to whom they accrue, that will exceed the overall cost of the initiative. This differs from a business case as it accounts for all benefits accruing to other parties such as patients that may have no part in sharing in the initiative's expense.

Star Ratings: Medicare health and drug plans are rated on a one-to-five scale based on their performance and quality, with one star representing poor performance and five stars representing excellent performance. The Centers for Medicare & Medicaid Services (CMS) rewards higher-performing plans with annual bonus payments, which must be spent on extra benefits for members.

Sunk Costs: Already-expended fixed costs. Also known as Retrospective Fixed Cost.

Surrogate Outcome: Outcome measures that are not directly relevant to the patient but are believed to be indicators of outcomes. For example, a physician may prescribe a lipid lowering medication to an individual at risk of a heart event, with the desired outcome being the avoidance of myocardial infarction. A surrogate outcome of such intervention would be the measurement of how successful the treatment has been in reducing that individual's lipid levels.

RAF (Risk Adjustment Factors) Scores: A medical risk adjustment model used by the Centers for Medicare & Medicaid Services (CMS) and insurance companies to represent a patient's health status. RAF scores are used to predict the cost for a health care organization to care for a patient and are the bases for per member per month (PMPM) payment adjustments to Medicare Advantage plans.

Value: The ratio of quality measures such as health outcomes and patient satisfaction divided by the cost of creating such outcomes.

Value-Based Payments: Incentive payments made to health care entities tied to the quality of care provided.

Value Proposition: A business or marketing statement that summarizes why a customer should buy a product or use a service; an effective statement convinces a potential customer that one product or service will add more value or better solve a problem than other similar offerings.

Variable Cost: Cost that changes with the volume of an activity undertaken. Also known as differential, incremental or relevant cost.

Working Capital: The capital of an organization which is used in its day-to-day operations, calculated as current assets (mainly cash and accounts receivable) minus current liabilities such as accounts payable.

Wong Pocket: Situation in which one entity pays for health intervention and the resulting benefits, such as cost savings, accrue to another unaffiliated organization that has no part in incurring the cost that brought about the benefits. For example, a Medicare Advantage plan could invest in costly disease prevention efforts for a beneficiary that take several years to produce noticeable outcomes, but when that individual disenrolls and becomes the responsibility of another MA plan, that first plan has then taken on the burden of the costs yet the second plan reaps the reward of a healthier beneficiary.

For more information about contracting, browse visit the Aging and Disability Business Institute's Contracting Toolkit (**https://www.aginganddisabilitybusinessinstitute.org/adbi-resource/contracting-toolkit**), which includes Contracting Do's and Don'ts, A Lexicon of Contracting Terms, a Guide to Insurance in Contracting, and Model Contracts for Community-Based Integrated Care Networks and Lexicon of Terms.

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