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Client Alert

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Choosing the Correct Financial Model for Purchased Services

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Many hospitals and health systems that want to outsource the operation of their food services departments or environmental services/housekeeping departments to third-party contractors are not sure what type of financial arrangement is best for their organizations. Alternatively, they may have existing arrangements with contractors that are simply not meeting their financial and operational goals. In order to determine which type of financial arrangement is best, it is helpful to understand the three most common types of purchased services financial models that are available from contractors and the pros and cons of each.

Model #1 – Management Fee

In a management fee financial model, the contractor charges a management fee to the hospital for its services and passes the contractor's cost of doing business on to the hospital. If the service involves revenues (e.g., a contractor who is operating a food service retail area), then the hospital will be entitled to receive the benefit of those revenues. More specifically, the hospital will retain those revenues directly or the contractor will keep the revenues and provide a credit for the revenues against the amount the hospital owes for services.

Model #2 – Profit and Loss

In the profit and loss financial model, the contractor charges a fixed rate for its services. If the service involves revenues, then the contractor typically retains those revenues. Depending on the service, there may be charges for items or services in addition to the fixed-rate charge for services. For example, in food services, most contractors will bill for catering, floor stocks, nourishments and supplements separately because the contractor does not have control over service volumes for those items and as such is typically unwilling to include those costs in a fixed rate.

Model #3 – Management Fee With Guarantee

The management fee with guarantee model is a hybrid between a management fee contract and a profit and loss contract. From a billing standpoint, the management fee with guarantee contract replicates a standard management fee contract in that the contractor charges the hospital a management fee and the hospital reimburses the contractor's costs. However, unlike a "standard" management fee contract, the management fee with guarantee contract also includes a financial guarantee that typically takes the form of an exhibit to the agreement that includes an annual budget that is mutually agreed upon by the parties. At the end of an agreed-upon annual period, the parties will reconcile actual costs to the agreed-upon budgeted costs. If actual costs turn out to be higher than budgeted costs, the contractor typically is required to reimburse the hospital for the costs in excess of the agreed-upon budget. If actual costs turn out to be less than the budget, the hospital typically will pay the contractor a percentage of the savings generated by the contractor.

Preliminary Comparison of Payment Rates for Office Visits (Established Patients)

The following table summarizes the key pros and cons of each financial model.

	Management Fee	Management Fee with Guarantee	Profit and Loss
Transparency	Yes	Yes	No
Contractor Financial Accountability	No	Yes	Yes
Simple to Apply	Yes	No	Depends
Hospital Control over Operations	High	Medium	Low

Management Fee. A management fee contract is fully transparent and is simple to apply because the contractor bills a management fee and passes its costs to the hospital. For this reason, the management fee contract also provides the hospital with the most control over the contractor's operations because the contractor is passing its costs onto the hospital. However, the hospital is disadvantaged in that the contractor does not have any financial accountability if costs exceed the hospital's budget.

Profit and Loss. The profit and loss contract is the least transparent financial model. The contractor bills a fixed rate, so the hospital does not know the amount of the contractor's profit, except for the rare instance when the contractor agrees to an "open book" profit and loss contract. A profit and loss contract may be very simple to apply if the contract only involves a fixed fee for services. However, in some situations, like food services, a profit and loss contract can be extremely complex. While most of the contractor's expenses in a food service contract are built into the contractor's fixed rate, other items—such as catering—are either billed in addition to the fixed rate or subject to an annual "cap" where a certain amount of cost is included in the rate and, if the cap is exceeded, the contractor starts billing the hospital for the amounts above the annual cap.

The hospital in a profit and loss contract does not have as much control over the contractor's operations as it does with a management fee contract because the contractor is financially accountable for operational changes that will create increases in costs or decreases in revenues. Consequently, if the hospital wants to add staff or expand services, then the hospital is required to negotiate a new rate with the contractor to cover the change in scope of services before it can implement the desired change. In addition, the fixed rate is typically based on contractually identified assumptions, such as the number of square feet cleaned, the hospital's projected annual census and/or the number of workers employed by the hospital. If those assumptions turn out to be incorrect, the contract likely will permit the contractor to obtain an adjustment to the fixed rate. Accordingly, a contractor's fixed rate contract may not be completely set in stone; instead, some profit and loss contracts may include specific charges in addition to the fixed rate or contractual exceptions that permit adjustments to the fixed rate.

Management Fee With Financial Guarantee. The management fee with financial guarantee contract is fully transparent and holds the contractor financially accountable. It is a useful tool to bridge the gap between a management fee contract (which has full transparency but no financial guarantee) and a profit and loss contract (which has a financial guarantee but no transparency). However, it is the hardest of the financial models for a hospital to implement because it requires the reconciliation of a department's actual costs against the department's budget after the conclusion of each annual period. A hospital must be willing to put in the time and resources to work with the contractor to complete the annual reconciliation in order to make the management fee with financial guarantee contract successful. Many of the assumptions related to the number of square feet cleaned, patient census, the number of employees in the hospital's workforce and changes to scope of services that are applicable to a profit and loss contract will also apply to the management fee with financial guarantee contract. These assumptions prevent the contractor from being held financially responsible for additional department costs or reductions in revenues due to circumstances that are outside of the contractor's reasonable control or from obtaining a financial benefit from reductions in department costs or increases in revenues due to circumstances beyond the contractor's reasonable control. For example, if a hospital's census increases, then the annual reconciliation should include a mechanism to account for the additional costs arising out of the census increase so that the contractor is not held financially responsible for those costs. Likewise, if census declines, then the annual reconciliation should include a mechanism to account for the financial impact of the census decrease on the department's budgeted costs. Accordingly, it can take a significant amount of time and effort to reconcile actual costs to a budget, particularly if a number of issues arise during the year that increase or decrease department costs or revenues due to circumstances beyond the contractor's reasonable control.

In some cases, hospitals have agreed to a financial guarantee in connection with a management fee contract only to end up not completing the annual budget reconciliation to confirm whether the contractor met the agreed-upon budget. As such, if your organization is not willing to commit the time, effort and recordkeeping needed to reconcile the budget at the end of each year, then a management fee with guarantee model may not be appropriate.

Tax-Exempt Bonds

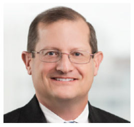
If the services are going to be performed at a facility that was funded by tax-exempt bonds, then you should consult with your legal counsel to determine whether the proposed financial model complies with IRS Rev. Proc. 2017-13. This is particularly true in connection with food services or any other services that involve a combination of expenses and revenues, since many bond counsel will not permit a hospital to use a profit and loss contract in that situation.

Conclusion

Each purchased services financial model has its own pros and cons. Determining which financial model is best for your organization ultimately comes down to finding the financial model that aligns with your organization's priorities. An organization looking for contractor transparency should avoid using a profit and loss financial model. An organization looking for contractor financial accountability should avoid a management fee contract that lacks any financial guarantees. An organization looking for simplicity should avoid a management fee with guarantee financial model. A thoughtful analysis of your financial and operational goals compared to the pros and cons of the financial models outlined in this article will help you determine the best financial model for your organization and increase the likelihood of a successful relationship with your contractor.

Health Care Team

Primary Contacts



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