Pricing decisions and profit essay

In most situations, providers are neither pure price setters nor pure price takers. Rather, for some services or in some markets they will be able to act as price setters; for other services or in other markets they will be price takers.

5. 2 Full-cost pricing recognizes that to remain viable in the long run, healthcare organizations must set prices that recover all costs associated with operating the business. Thus, prices are set to cover (1) the direct variable costs of providing the service, (2) the direct fixed costs, and (3) an appropriate share of the overhead expenses of the organization.

In addition, one could make a strong argument that full-cost pricing should recognize that a profit impotent is necessary to support growth and, for investor-owned businesses, to provide a return to the suppliers of equity capital.

Under marginal-cost pricing, prices are set to cover only the marginal (typically the variable) costs associated with the service. 5. 3 Under full-cost pricing, prices are set so that all costs, including the required profit component, are recovered.

In this situation, the business will be able to support growth and sustain its economic viability over time.

When prices are set on the basis of marginal costs, the organization will not recover its total costs, including both direct and overhead fixed costs. With no revenues to cover these costs, the business would ultimately fail. In theory, no services should be priced on the basis of marginal costs. However, it may make sense to use marginal cost pricing temporarily to build market share or to respond to disequilibrium conditions in the market for healthcare services. .

4 under cross-subordination (price shifting), some patients or covered populations are overcharged for services, as compared to full costs, while others are undercharged. Historically, price shifting was used by providers to support services, such as emergency care, teaching and research, and indigent care, which were not self-supporting. Without such price-shifting strategies, many providers would not have been able to offer a full range of services. Historically, payers were willing to accept price shifting because the additional burden was not excessive.

Today, however, overall healthcare costs have risen to the point where the major purchasers of healthcare services are not willing to support the costs associated with providing services to others, and hence purchasers are demanding prices that cover only true costs, without cross-subsidies. Payers, perhaps rightly, believe that they do to have the moral responsibility to fund healthcare services for those outside Of their covered populations. Copyright 2012 Health Administration Press 5-1 5. 5 a. Target costing focuses on costs rather than prices.

In essence, a target costing analysis takes the price of a particular service as given and then determines what costs are needed to break even or to earn some target profit.

Then, the business’s managers attack the cost side to ensure that profitability goals are met. Target costing explicitly recognizes that profits are a function not of prices alone but rather of both prices and costs. B. If we assume the hospital's goal was to earn a 5 percent profit on the contract, or 0. 05 x $40 PM = $2 PM, the tangible costs associated with the contract must be held to $38 PM.

Budgets would be created and utilization and cost targets established to try to ensure that costs associated with the contract fell at or below the target.

5. 6 a. Profit analysis, or more formally, cost-volume-profit (CUP) analysis, is a type of analysis used primarily to assess the effects of volume changes on costs, revenues, and profit. Additionally, it is used to assess the effects Of alternative assumptions regarding costs, volume, and prices.

B. CUP analysis is very useful to managers as they evaluate the potential impact of alternative future courses of action.

It can be used to examine an almost unlimited number of price, volume, and cost scenarios to see how different courses of action affect profits. C.

A profit and loss (P&L) statement is a listing of revenues, costs, and profits for a department or service (or some other entity). The idea here is to get a feel for the profitability of the entity and how that profitability was achieved. The specific format of a P&L statement is quite flexible, so it can be constructed to best meet the information needs of a particular managerial session. 5.

7 a.

Contribution margin is defined as the difference between per unit revenue and the variable cost rate (per unit variable cost). B. The contribution margin is the dollar amount per unit of output (per visit in the text example) that is available to cover fixed costs and ultimately create a profit because variable costs have been accounted for in the calculation of the contribution margin.

The total contribution margin, which is volume multiplied by the contribution margin, first must be applied to pay for fixed costs; any remainder represents profit.. . 8 a. Here are two forms of the equation for volume breakable: Total avenues -? Total variable costs – Fixed costs = $0. Or (Price x Volume) – (Variable cost rate x Volume) = Fixed costs.

In general, breakable occurs when profit is zero, so breakable occurs at that volume that produces total revenues equal to total (variable plus fixed) costs. B. Accounting breakable occurs when accounting costs are covered (as in the equation above). Economic breakable occurs when accounting costs plus a profit goal are covered.

Thus, the economic breakable equation is as follows: Total revenues – Total variable costs – Fixed costs = Profit.

Or (Price x Volume) – (Variable cost rate x Volume) Fixed costs + profit. -2 5. 9 In a fee-for-service environment, additional utilization means additional revenues for providers. In other words, the total revenues line on a CUP graph is upward sloping. Under capitation, the total revenues line on a CUP graph is flat, which changes the entire relationship between volume and profit.

Under capitation, less utilization rather than more utilization enhances profitability because under capitation each additional visit creates costs without a corresponding increase in revenues.

5. 10 under fee-for-service, the Incentive is to increase patient utilization. Under vitiation, the incentives are to increase the number of members in the covered population but decrease per member utilization. Thus, the incentives are quite different, so to succeed and prosper under capitation, healthcare managers have to fully understand its implications for profitability and create the appropriate behavioral change.

. 11 a. When a provider is captivated, the best cost structure (the cost structure that minimizes financial risk) is one that consists of all fixed costs. If we assume that captivated revenues exceed fixed costs, the profit (assuming a constant covered population) is " locked in.

B. When a provider is reimbursed mostly under fee-for-service, the best cost structure is one that consists of all variable costs. As long as the revenue per unit of output exceeds the variable cost rate (cost per unit of output), a profit is earned on each unit.