CHAPTER 2
CONCEPTUAL FRAMEWORK

2.1 Business Model Definition

Business Model is a framework for making money and consisted of a set of activities which an organization performs, how it performs them, and when it performs them as it uses its resources to perform activities, given its industries, to create superior customer value and put itself in a position to appropriate the value. In the not-for-profit organization, the fund received through the business model comes from other resources, for example government. The fund then will be used to support the activities and gives values to customers. We can see here that there would be no doubt about the general trend of not-for-profit embracing the business model, concepts and techniques of for-profit business and industry. An organization's business model outlines the key components of its business approach and therefore explains how its business strategy will deliver value to customer in a profitable manner.

2.2 Not-for-profit and for-profit Management

For years, the task of operating a not-for-profit was considered administration, from the Latin "*administrare*", "to serve." The term was used as a substitute for management, which was associated in the public mind with business and profit making. However more recently, both the academic world and professional became aware of the needs of not-for-profit to transform its early definition. Professionalized not-for-profit management then incorporates concepts and techniques almost exclusively from for-profit business and industry. Perhaps this reliance on for-profit models stems from the financial uncertainty in which not-for-profit organizations have found themselves during the past several decades. Government budgets have been cut even while needs have continued to grow. Organizations under stress look to outside models they perceive as successful and promising. The social services industry is in a period of transition

marked by the entry of for-profit organizations that compete directly with not-for-profit for government contracts. For-profits entering the social services industry enjoy four distinct advantages: size, capital means capability, mobility, and responsiveness. In an attempt to compete head to head with for-profits, not-for-profit in the industry are adopting for-profit management models in hopes of sharing these advantages.

The for-profit business model to which the not-for-profit sector has looked for salvation is usually a series of management models emphasizing quality (of products or services), efficiency (cost management), flexibility (assuring adaptation to change), innovation (striving for improvements in products and services), and above all a disciplined focus on the financial bottom line. But adoption of this model has not occurred without consequences. Consider the following:

- More business people are recruited for not-for-profit boards of trustees because of their influence, money, and business expertise.
- Not-for-profit are understandably encouraged to hire staff, especially senior executive staff, with business expertise and skill as opposed to mission-related acumen. In addition, non-mission-related outside consultants, such as accountants and attorneys, are brought in to address issues such issues as financial accountability and risk management.
- New for-profit management systems, which emphasize productivity, quality assurance, budget discipline, or strategic planning, are forced on a mission-oriented staff.

Much of the above is undeniably good for public charities, especially those plagued by financial ills delivery of services. However, the following side-effects are often troubling:

- Boards of directors tend to be underused for their proper role of assuring mission integrity, strategic planning, and high-level policy-making. Business-oriented board members are inclined to emphasize financial issues over mission issues. When they micromanage, their focus on

financial issues exacerbates the problem by diverting even more staff time and resources away from mission activities.

- Psychological distancing develops between management and program staff. People of different orientations are drawn to these different roles. Management's focus on financial health and program staff's concerns with mission delivery create two camps in the organization, each failing to understand and communicate with the other.
- As management's decisions are increasingly driven by managers' natural interests and familiarity with financial issues, mission concerns are deemphasized. This can diminish morale among program staff members who are uncomfortable with the new procedures and unfamiliar with their advantages.
- Public image suffers. To paraphrase an old saying, "If you walk like a duck and quack like a duck, eventually people will think that you are a duck." As not-for-profit organizations increasingly resemble for-profit organizations, they look less and less like the public charities they are meant to be. Donors are less inclined to support organizations outside their traditional notions of public charities. When donors cease to recognize these organizations as public charities, they stop supporting them. This in turn causes management to rely on commercialism to sustain financial viability. The problem compounds itself. With the best of intentions, an organization seeking to assure its financial health ends up trading one set of problems for another

2.3 Component of a not-for-profit business model

Since business model are about making money for funding, first thing we have to consider for a not-for-profit business model is that they must also depends on the factors that determine their profitability. An organization's profitablity is determined by both industry and organization specific factors (position, activities and resources). There are three primary industry factors that influence profitablity of an organization:

- competitive forces in the industry,
- the influence of the overaching macro environment on the industry, and
- the cooperative forces between the the organization with the suppliers, customers, rivals and potential new entrants.

The four component is shown below along with the fifth component –cost. The rationale to put cost as the fifth component is because to perform an activities within an organization will generates cost, regardless whether they pursue low cost or differentiation strategy (Gamble and Thompson, 2007).

Figure 2.1 Component of a Business Model

Source from Crafting and Executing Strategy by Gamble (2010)

Business model is a framework for making money. Money comes from customers who pay for the benefits that they value in services. A critical part of a business model is offering customer that value which will allows the firm to charge premium prices for the superior value and generates revenues. This premium charge strategies for not-for-profit organization must be thoroughly implemented to pursue their socio-economic objective. However how much they

can charges for superior value depends on the bargaining power that have over its customers, suppliers, rivalry in the industry, the barriers to entry and viability of substitute services.

Table 2.1 Segmentation of Market and its Value to The Organization

Activities of Organization	Mass market	Market Segment	Individuals
Needs and Preference Identification	One-to-all	One –to-segment	One-to-one
Value Creation and Delivery Approach	Marketing Mass production	Marketing Mass production Mass Customization	Marketing Customization Mass Customization

Source from Crafting and Executing Strategy by Gamble (2010)

In offering value to its clients, an organization faces important choices. It usually must decide which clients in the market that it serves should they target. They can target the entire market as if all clients had the same needs, individual or target market segments. Both the way the organization identifies client's needs and preferences and the approach the organization uses to create and deliver clients values depend on the client target that the organization chooses. In selecting target clients, we must recall that the goal of a not-for-profit organization is to make money (raise fund) and the organization provides benefits as:

- it offers products or services at a lower cost or more efficient and
- there are enough clients that need the product or services.

Organization may find it worthwhile to explore the following characteristic of potential targets which are the market size, affordability, attractiveness of target and organization specific factors that are suitable for not-for-profit motives.

For-profit making organization depends on revenues obtained from the sales of its goods and services to customers, who typically pay for the cost and expenses of providing the product or service plus a profit. Not-for-profit organization, in contrast, depends heavily on dues, assessment or donations from its membership or on funding from sponsoring agency to pay much of its cost and

expenses. revenue is generated from a variety of sources – not just from clients receiving the product or services from the not-for-profit. it can come from people who do not even receive the services they are subsidizing.

To understand revenue and funding of a not-for-profit hospital, first we need to see that healthcare service system runs from two concept of goods, public and private. Public goods according to Katz and Rosen (1998), has several characteristics:

- Non-rivalry , the service used by one customer will not reduce the value of service needed by the other customer, therefore they do not have to compete for the service.
- Non-excludable, we can not prohibit customer to use the service even though they do not want to pay for it.
- Positive externality, public service to a customer will impact positively to other person who did not used the service. For example, when a child have an imunization, we will reduce the risk of transmitting disease to other children.

In contrast to that is the concept of private goods which have the opposite characteristics such as rivalry and excludable, even though the positive externality still exist. Examples of public goods service for a hospital is sanitation program, health talks program to society or companies, imunization, etc. While the example of private goods service are VIP rooms, plastic surgery service, private surgery and others. Public goods services are usually subsidized by the government. This understanding of public and private goods is important in analyzing the health funding policy. Below figure is the map of health fund sources in Indonesia:

Figure 2.2 Map of Health and Fund Resources in Indonesia

Source from Memahami Penggunaan Ilmu Ekonomi Dalam Manajemen Rumah Sakit (2009)

Pattern of influence on an organization's strategic decision making derives from its sources of revenue. regardless of percentage of total funding that a client generates, client may attempt to directly influence a not-for-profit organization through the sponsors. The key to understanding the management of not-for-profit is learning who pays the delivered service. if the recipients of the service pay only a small proportion of total cost of the service, strategic managers are likely to be concerned with satisfying the needs and desires of the funding sponsors than those of the people receiving the service. Healthcare service system in Indonesia are being fund by both government and private sectors. In general, private sectors holds 70% of total fund based on the report of Health Ministry in 2001. This fund are mostly being used for individual health care system (private goods). Other than that, Government and world wide organization are also the sources of fund.

2.4. Analyzing the Cost Driver

Cost drivers are the basic factors that determine costs. Thus, the cost driver of a business model are the factors that are associated with the organization resources, activities, positions and industry that have casual effect on the model costs. Creating value for clients and stakeholders requires resources (or asset) such as plants, equipments, patents, skilled scientist, distribution channel, etc. Asset or resources can be categorized as tangible, intangible, and human. tangible asset can be physical such as plants and equipment or financial such as cash. Intangible asset are nonphysical and non financial asset such as patents, brand, trade secrets and relationship with vendors. human asset are skills and knowledge that employee carry with them. as important as asset are, it usually takes more that asset to offer value to stakeholders. an organization ability or capacity to turn it resources into value is called competence or capability.

If we are using production concept as our base, then the objective of analyzing the cost in a not-for-profit organization such as a hospital are:

- Give an understanding of health care services and procedure on each production line. Therefore, this cost calculation can be expected to help the hospital management concerning cost and expenditures of each section, department or activities in order to control the financial transaction and increase efficiency.
- Act as a monitoring tool to control the cost and avoid uneccessaries expenditures.
- Help decide production places that is benefiting the hospital or make them lost. The data here can become the base to analyze the pricing strategies for the hospital.
- As a basis for comparison with their competitor in terms of service quality and pricing strategy.

However, before we try to analyze and control the cost, there are three basic requirements: (1) appropriate hospital organization structure; (2) precise accounting system; (3) comprehensive statistic information system. Most used accounting system in heath care industry is Activity Based Costing Model (ABC)

which is design based on the concept of every service or product produce is need an activity.

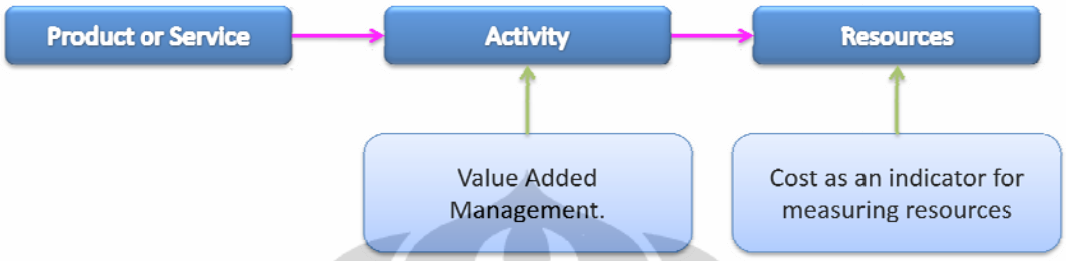

Figure 2.3 ABC Concept

Source from Memahami Penggunaan Ilmu Ekonomi Dalam Manajemen Rumah Sakit (2009)

ABC concept generally used to increase cost effectivity and efficiency on each aspects of organization that captures in activities based costing. To obtain effective and efficient organization, we have to generate a cost system based on the activities in order to produce something.

There are several cost concept that we need to consider when we want to analyze the cost driver for a not-for-profit organization like hospital:

- *Fixed Cost*, For example a hospital with VIP rooms who has 15 beds. Despite the fact that they have 80% or 20% of patient rate for VIP, the hospital still have a monthly cost of IDR 2,000,000. This kind of cost is consider as a fixed cost. In the long term, however, all of fixed costs are considered as variable, therefore its concept can only be analyze in short period of time.
- *Variable Cost*, variable cost is a function of output changes. The example of variable cost in a hospital is the number of daily inpatient, health care staff, foods, medicine, and others.
- *Semi-Variable Cost*, due to just a slight difference between fixed and variable cost, there comes one concept of semi-variable cost. To be consider into this type are cost behavior who has increasing tendency based on their activities volume, however they also have a fixed tendency.

To state an example is in food department at a hospital where they serve approximately 251 up until 375 food per day and still manage to make the cost the same due to the same number of man power.

These concept of cost can be usefull when we want to generate the appropriate pricing strategy as well as to analyze the cost drivers. Pricing strategies are as complex and varied as the hospitals that employ them. The science of developing a pricing strategy lies in determining how to meet a series of competing objectives: balancing budgets while remaining competitive, complying with regulatory standards, providing community benefit, and withstanding legal scrutiny.

The industry is responding to the push for transparency in a variety of ways, including taking a hard look at pricing strategies. Although every hospital has a pricing strategy, some are more sophisticated than others. If a hospital's pricing strategy is driven solely by the desire to meet a budget, without a more deliberate, fact-based assessment of costs, contracts, and market conditions, that hospital will continue to be vulnerable to attack. A sound pricing strategy needs to incorporate a range of complicating factors, including the impact on the brand, payer contracting, compliance, competition, the cost of education and research, and the implications of consumerism. For example, consumerism is beginning to drive providers to reduce costs, change utilization, negotiate new contracts and rates, focus on quality reporting, and create new competition, such as express care clinics. Healthcare providers executing pricing initiatives need to consider these external influences to fully understand the healthcare pricing environment.

Internally, financial managers need a way to analyze their existing charge structure to ensure that it is optimal, that it can be defended, and that net patient revenues and third-party payments are being fully realized. Organizations should develop dynamic pricing migration strategies that are customized based on the market and the organization's competitive position and that incorporate three critical factors: costs, comparative market data, and payment. The process should begin by analyzing hospital charge data at the department and procedural level to determine each procedure's contribution to charge-based, cost-based, and fixed

revenues. Once this analysis has been completed, the goals and parameters for desired gross or net revenues changes should he defined. A more sophisticated approach to establishing hospital pricing strategies should include:

- Reevaluating billing policies and processes to establish payment plans and protocols for collection
- Establishing a predictable and accurate pricing schedule for all services based on variables such as market, cost, and fee schedules
- Leveraging Information Technologies to guide decision making
- Informing hospital boards of the basis for pricing strategies

2.5. Competition & the Environment

There are consistent differences between the benefit acquired in different industries that suggest there is something about some industries that allows the organizations within those industries to be more beneficial, on average, then organization in other industries. moreover, within each industries there is something about some organization that makes them more beneficial than their rivals. this is the industry specific factors.

- Competitive force : if a supplier have bargaining power over the organization, the organization can end up either paying more for its supplier, being forced to take inputs of lower quality than their price rate, or both. Paying more means higher costs for the organization. Powerful customer can force an organization to add more features to their service than it should, given the prices that it is receiving from its service, such additional features can be expensive.
- Cooperative force : cooperation in industry can play an important role in the cost of the activities that the organization in the industry perform. Since customers can be sources of innovation, cooperating with them can reduce the cost of exploiting such innovation.

- Macro environment : an organization's overaching environment of government policies, fiscal and monetary policies, judicial and legal systems and technological change can impact its costs.

Not-for-profit indutry and environment are surprisingly complex by comparison to for-profits. The "law of not-for-profit complexity" argues that they "tend to be more complex than business firms of comparable size" (Anheier, 2000: 7). Not-for-Profit environment requires managing diverse constituencies and stakeholders, including a professional core of managers, a governing board of experts and community representatives, a client or user base and their representatives, a volunteer and membership component, and actual service providers. Not-for-profit also must manage a set of contractual relations with both government and business, as well as multiple revenue sources, including donations, fees, charges, subsidies, grants, and contracts. As a result of this diverse list of constituents, stakeholders, obligations, and revenue sources, not-for-profit have, in effect, multiple bottom lines.

Some for-profit management models need serious modification for the not-for-profit environment. Bryce (1999) argues that the financial functions in not-for-profits and for-profit organizations differ in fundamental ways:

- For-profit organizations fund growth and finance new initiatives through retained earnings, stock sales, and borrowing. There are no stockholders in a not-for-profit. not-for-profit leaders therefore need to be more innovative in exploiting other revenue sources, such as contributions and assessments of membership.
- For-profit organizations commonly have large investors who own the organizations and may even exercise total control. In not-for-profit organizations, large contributors are prohibited from exercising unbridled control.
- not-for-profit public charities must demonstrate that a large portion of their revenues comes from public support or that they are owned by a publicly supported organization. For-profits face no such requirement.

- not-for-profit sector often has prohibitions against certain types of investments or investment strategies, such as commodity and options trading. Again, for-profits face no such rule.

Non-profit hospitals often fit a consumer cooperative model. In a sense, they are the captives of patients and donors. Such a situation could explain a greater quantity of charity care or lower prices. However in reality, it is unlikely that one group completely controls the hospital. Like the formation of public policy, each special interest group is pushing the hospital in directions that promote its welfare. How successful it will be depend on the resources at its disposal, political skills of its members, and the rules of the game. Since these will differ for each group and the difference between groups will differ at each hospital, we cannot predict how a particular not-for-profit hospital will appear or behave.

The most important constraint on the influence of these groups is the competition faced by the hospital. The comparative statics of the response to market conditions by a not-for-profit hospital should mirror that of the for-profit hospital with which it must compete. Competition dictates the behavior of the not-for-profit hospital, not the ultimate pecuniary and nonpecuniary goals of the special interest groups. In the end, its prices, costs and level of efficiency will be on par with its for-profit competitors. There are also its own interests of greater prestige (and income) through the optimum balance of quality and quantity. That is, administrators of not-for-profit hospitals gain prestige through their management of large hospitals that provide an ever increasing number of complex procedures. They are not alone in the push for increased quality and quantity. The goals of the other special interests demand increases in the number of services the non-profit hospital provides and in the number of patients treated. Physicians, endowed with the power to induce demand for their services, will pressure the hospital to provide more beds, nursing staff, and surgical facilities.

2.6. Empirical Studies

Based on the journal by Jill R. Horwitz and Austin Nichols about "What do not-for-profits maximize? Not-for-profit hospital service provision and market ownership mix", there are four major categoriries of not-for-profit firm theories. These chategories are:

- Firm Output Maximization Theories

  Where not-for-profits maximize own output, they will offer more health care until profits are driven to zero. It may seem that managers of not-for-profit hospitals should be relatively indifferent to the mix of hospitals around them, since their neighbors cannot dictate output decisions. Some theorists have sought to explain that this is the case because certain kinds of actors control not-for-profits: managers with particularly altruistic goals (Rose-Ackerman 1996) or consumers who control the mission of not-for-profit organizations institution directly (Ben-Ner 1983; James and Rose-Ackerman 1986; Ben-Ner and Gui 1993). A not-for-profit's neighbors, however, will take some of its "customers" and thereby affect its patient pool. If their neighbors are driven more by profit motives, then the not-for-profit will tend to treat less profitable patients who seek less profitable types of care. In this case, the not-for-profit's behavior will be affected through the binding constraint on profits—in the absence of the profit-seeking competitors "cream-skimming" patients, they would have offered a mix of services (and served a mix of patients), that generated zero profit, but in the presence of the profit-seekers, so they must alter their behavior to generate additional profits. Thus a not-for-profit will be induced to look more like a profit-seeker in an environment where there are more profitseekers, by both being less likely to offer unprofitable services and more likely to offer profitable ones.

- Market Output Maximization Theories

  Weisbrod (1988) suggests that not-for-profits maximize total market output, meeting community health care needs where market and government failures leave them unmet. Salamon (1987) models government, rather than the voluntary sector, as the residual sector. Frank

and Salkever's (1991) model includes total industry output as a maximand. In a theory of not-for-profits that maximize market output, not-for-profit hospitals may attempt to generate more revenue by adding more profitable services, but they also will react to a mix of neighbors that is more profit-seeking by increasing their propensity to offer less profitable services or to serve less profitable patients to offset the more mercenary behavior of their neighbors. Thus a not-for-profit will be induced to look less like profit-seekers in an environment where there are more profitseekers,

in at least one way, by being more likely to offer unprofitable services, and more like profit-seekers in that it may also become more likely to offer profitable services.

- "For-profit" in disguise Theories

  Researchers have suggested that both not-for-profit and for-profit hospitals maximize profits, but profits go to shareholders in the case of for-profits and privileged employees

  in the case of not-for-profits. Pauly and Redisch (1973) develop a set of three models in

  which staff physicians capture all rents from not-for-profit hospitals. While some distortions may arise from operating hospitals to benefit a subset of physicians, two of their models imply that such hospitals would be essentially identical to for-profit hospitals in equilibrium, with economic profits counted as costs (salaries or perks accruing to staff physicians). Many empirical findings have demonstrated that not-for-profit and for-profit hospitals are substantially alike in important ways (cost, revenue, profits, etc.) (for a literature review see Sloan 2000). Evidence that not-for-profits and for-profits are similar along many dimensions tends to support the theory that not-for-profit hospitals maximize economic (if not accounting) profits. If both not-for-profits and for-profits are maximizing profits, not-for-profits should not act differently depending on the proportion of for-profits in their markets.

- Mix of Firm Output and disguise Theories

  Hirth (1997, 1999) develops a theory based on competition over quality under which competition from non-profit maximizing not-for-profits causes positive spillover effects on the performances of both for-profits and "for-profits in disguise" (i.e., not-for-profits that are solely motivated by profits). According to the theory, not-for-profits drive out low-quality for-profits (that charge high quality prices) and increase the utility of the uninformed consumers who continue to seek care at for-profits. Hirth concludes that quality differences can disappear in markets with a sufficiently high proportion of not-for-profits. Even under this fourth model (Hirth), where only some not-for-profits are profit-seekers, an increase in for-profit penetration (holding constant numbers and sizes of neighbors) should only affect behavior to the extent that the not-for-profits displaced are not profit-seekers. Thus the hybrid model offers a hybrid prediction, somewhere between the Pauly-Redisch model that predicts that not-for-profits will look essentially like for-profits, and the Newhouse model that predicts that not-for-profits may look more like for-profits in the presence of more for-profits. Still, it would be unlikely to find differences among ownership types if the variation within the not-for-profit form was greater than the variation between not-for-profits and other types.