Part I

1 Introduction to Healthcare Finance

Learning Outcomes

After reading this chapter, the student will be able to:

- Identify the different accounting authorities and their functions within the accounting process.
- Explain the process by which financial reports are generated and the accounting principles that govern this process.
- Describe the objectives for financial reporting and the impact this has on the management process of an organization.
- Identify the different types of financial transactions in a healthcare facility and the transactions in a healthcare facility that help to control the planning and forecasting of a healthcare organization.
- Describe the sources of financial data in a healthcare organization.
- Identify three uses of financial data and how they impact reimbursement in addition to planning and forecasting.
- Explain the various elements that make up the financial statements of the healthcare organization.
- Explain the different types of financial organizations, such as sole proprietorship, partnership, and corporation.
- Describe the characteristics of for-profit and not-for-profit organizations.

Introduction

Through the years, health care has evolved from paying cash to the physician at the time of the office visit or the visit to the home, and then the progression to insurance covering the visit. The changes that have occurred over the years have been from the patient having varying responsibilities with regards to payment for the services that ranged from paying the provider first and getting reimbursed from the insurance company in a major medical environment to paying a copayment or coinsurance amount to the provider and the insurance company paying the provider directly. This changing environment has placed many challenges on the healthcare provider and administrator. The timing on payment is different from most industries; for example, when you go to the store to buy lumber and supplies for a weekend project, you pay at the time of check-out in the form of cash or credit card. For health care, the patient receives services and leaves the facility, and the hospital or provider bills the insurance company several days later and waits for payment up to 45 days or longer. This process requires the healthcare administrator to be well versed in healthcare finance and general accounting principles.

This chapter will help to uncover some of the concepts and principles of the basics with regards to accounting by identifying and describing the accounting authorities that oversee financial transactions for federal and public organizations. Then the chapter will cover the objectives for financial reporting and the uses of financial information that will support the decision-making process in the running of an organization. This financial information that represents the data or transactions of an organization will help to compile various financial statements that will assist the for-profit or not-for-profit organization in their decision-making process. The sources of this data come from clinical services, patient accounts, the health information department, and administration. This financial data will help in the areas of reimbursement, control, and planning and forecasting for the healthcare organization.

Accounting Authorities

Federal Accounting Standards Advisory Board

The mission of the **Federal Accounting Standards Advisory Board (FASAB)** is that it "serves the public interest by improving federal **financial reporting** through issuing federal financial accounting standards and providing guidance after considering the needs of external and internal users of federal financial information" (FASAB 2014).

The FASAB is an independent organization that works towards setting the accounting standards for all businesses that operate in the private community (LaTour & Eichenwald Maki, 2013a, p. 766). The FASAB works to provide for public accountability through financial reports that include **financial statements** that are prepared in a format that is compatible with generally accepted accounting principles. The board for the FASAB plays a critical role in accomplishing the outcome of the government being accountable in the public's eye. The use of financial reports on the federal level will demonstrate the government's ability to show effective and efficient processes and social, political, and economic impact of various uses of federal resources.

The FASAB looks to improve the financial reporting of the federal government so as to meet its responsibilities to be accountable, and this is done through an independent process that is comprehensive and invites participation from all stakeholders. The FASAB strives to provide a timely and comprehensive study of issues, participation by various stakeholders involved in the standards-setting process, consideration of the costs involved with and the benefits of the financial information, common understanding of the information obtained via financial reporting, availability of informal and formal guidance for preparers and auditors, and holding itself accountable through transparency and comprehensive governance practices.

The FASAB sets the accounting standards for federal and other entities that will assist them in selecting the most applicable form of guidance to use in preparing and auditing accounting and financial reports and this is accomplished through two types of information sources labeled authoritative and other. The authoritative source is considered to be the *FASAB Handbook of Accounting Standards and Other Pronouncements*, or otherwise known as the *FASAB Handbook*. The other sources of information that the FASAB has developed include guides, reports, and other documents that are not considered to authoritative sources but can be appropriate if they are utilized in the proper environment.

Generally Accepted Accounting Principles

The term **Generally Accepted Accounting Principles (GAAP)** consists of accounting principles that are used in the preparation of financial reports and statements for businesses or entities. Generally Accepted Accounting Principles or GAAP "is often used to describe the body of rules and requirements that shape the preparation of the four primary financial statements" (Cleverley, 2012a, p. 182).

According to Wiley, GAAP establishes "the measurement of economic activity, time when such measurements are to be made and recorded, disclosures surrounding this activity, and preparation and presentation of summarized economic information in the form of financial statements" (Flood, 2014a, p. 2). GAAP comes into play when questions come about regarding how to best accomplish these items—and the end result is that GAAP will develop accounting and financial reporting standards. According to GAAP, there are two categories of accounting principles: recognition, which covers timing and measurement of items to enter the accounting cycle, and disclosure, which involves non-numeric issues such as reporting all data (Flood, 2014a, p. 2). If recognition and disclosure were not part of the financial statement process, the end result would be that statements would be misleading and would be missing information necessary for the person who is reading the statements to make or render a decision based on the information provided. Disclosure ultimately supports the recognition principles in that assumptions are explained that are part of the numeric information; these provide additional information to the person reading the financial reports.

Securities and Exchange Commission

The **Securities and Exchange Commission** (SEC) has a mission to "protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation" (SEC 2014a). With the changing marketplace and the increasing amounts of new investors to the market who are looking towards the future on ways to pay for new homes and college tuition through these markets, it has become an even greater need to regulate the market to sustain continued economic growth.

Investing in the market can be exciting and rewarding, and at the same time it can be dangerous as well. Deposits in a bank may be guaranteed by the federal government, but stocks, bonds, and other types of securities can pose a risk for losing their value. The SEC strives to have a straightforward approach to the laws and regulations that govern the securities industry, in which they look to make sure that all investors, regardless of their size, have access to basic facts about a particular investment or multiple investments through the disclosure of meaningful, timely, and accurate information from the public companies to the public or individual investors. This way, the individual investors can determine on their own whether to buy, sell, or hold a particular investment or security.

The responsibility of the SEC is to interpret and enforce federal securities laws, issue new and amend existing rules, oversee the inspection of securities firms, oversee private regulatory organizations, and coordinate regulations with federal, state, and foreign authorities (SEC, 2014b).

The SEC oversees securities exchanges, securities brokers and dealers, investment advisors, and mutual funds to ensure disclosure of market-related information and protecting against fraud. The SEC accomplishes effective oversight through their ability to enforce the laws through civil enforcement actions against **corporations** and individuals that violate these laws. These violations include insider trading, fraud, and companies providing misleading information surrounding the securities they issue. The SEC works closely with a number of other institutions such as Congress, various federal agencies, stock exchanges, state securities regulators, and other private-sector organizations.

Internal Revenue Service

The **Internal Revenue Service** (IRS) "is a department of the United States Treasury and is considered to be one of the most efficient tax administrators and in 2012 alone the IRS processed over 237 million tax returns and collected more than $2.5 trillion dollars in revenue" (IRS, 2014a).

The mission of the IRS is to provide to the American taxpayers the highest quality services surrounding their personal taxes and business taxes and helping them understand their tax responsibilities and in the process of doing this, enforce the law fairly and with the highest integrity. Overall, the IRS helps the taxpayer understand the laws that Congress passes and makes sure that they are compliant and for those who are not compliant, the IRS will make sure that they comply and are responsible for their fair share.

The IRS "is organized under the Unites States Treasury under the Internal Revenue Code, section 7801, and the secretary has the full power to administer and enforce the laws associated with the IRS and also has the power to create an agency to enforce these laws" (IRS, 2014a). The IRS is supervised by a commissioner who is appointed through the Internal Revenue Code.

Centers for Medicare and Medicaid Services

Medicare was established as a result of Title XVIII of the Social Security Act. This was designated as being "Health Insurance for the Aged and Disabled" (CMS, 2012), which is commonly known as Medicare. The Medicare legislation started a program that provided health insurance for persons over the age of 65 to complement other insurances a person may have, such as retirement benefits, survivor's benefits, and disability insurance benefits (Klees, 2009a). According to Centers for Medicare and Medicaid Services (CMS), the Health Insurance for the Aged and Disabled Act (title XVIII of the Social Security Act), or as we know it to be Medicare, has made this coverage available to almost every American over the age of 65 years old. In addition, this broad program is designed to assist the nation's elderly to meet hospital, medical, and other covered healthcare costs. The program includes two related health insurance programs called Hospital Insurance (HI) and a Supplementary Medical Insurance (SMI), which is under Part B (CMS, 2012). CMS will be covered in greater detail in later parts of this text.

Objectives for Financial Reporting

The objective of effective financial reporting is to provide information in a timely and efficient manner that will assist in the making of decisions regarding the allocation of resources for the organization. Managers need financial reports so the information about the organization makes sense in a way that will assist them in predicting future cash flows of the organization. This cash flow affects an organization's ability to meet its obligations, such as accounts payable, payroll, and loans, along with paying dividends to the shareholders. There are several information categories that provide information such as economic resources, claims against the entity, and owners' **equity,** which is where the financial reporting illustrates the organization's cash flows and identifies its strength, weaknesses, and solvency. Next, there is economic performance and earnings, which is where the organization looks at past performance to predict its future performance. According to GAAP, "in this instance, when an organization uses the accrual accounting method, it will be a better indicator of future cash flows and overall performance than using current cash receipts and disbursements" (Flood, 2014b, p. 18). The liquidity, solvency, and funds flows is information about cash and other funds from borrowing, expenditures, capital transactions, obligations, owners' equity, and earnings that an organization may experience. The management stewardship and performance is an assessment of an organization's management, measuring how effective they are with regards to managing the organization and the earnings that they report. Finally, management explanations and interpretations covers managers' responsibility to be efficient with regard to the use of the organization's resources.

Usefulness of Financial Information

Financial reporting is a tool for providing information to decision makers that will influence and support the decision-making process. Information for the purposes of decision making need to have the following traits, including usefulness for the decision, relevance, faithful representation, comparability, verifiability, timeliness, understandability, trade-offs, and cost constraint.

The first area is *usefulness for decision-making*. According to GAAP, this "is considered to be the most important characteristic of information for the organization and the information must be useful and have benefit to the user and the accounting information must be relevant and faithfully represent what it claims to represent" (Flood, 2014c, p. 20). These two characteristics are impacted by the overall completeness of the information reported.

Relevance of information is determined by whether the data provided can impact the individual's decision-making process, as it can influence the ability of the person to effectively predict **events** or to accurately authenticate expectations. Even though the information provided may not ultimately change the person's decision process, it can reduce the level of uncertainty of the outcome of the decision. Information is necessary and relevant if it provides understanding surrounding past and future events, and if it is timely. In addition, based on the materiality of the information to the organization, information should be reported if it has value to the organization.

Faithful representation is where financial statements demonstrate the important financial relationships of the organization itself. For information to be considered faithfully representative, it must be complete, neutral, and free from errors (Flood, 2014d, p. 20). A *complete representation* contains all information, such as quantitative and descriptive information, that can be used in a decision-making process. Another area related to faithful representation is *neutrality*. This is where accounting information is a tool to communicate without providing any influence that would sway a decision in a particular direction that would favor a particular interest group. The term *free-from-error* is not meant to identify the information provided as being perfectly accurate, but it does mean that the information or description is accurately described and there is an explanation of any unusual occurrences.

Another feature that will generally enhance the information is *comparability*, which means that, at the time that information is relevant and faithfully represented, it can be used to assess the similarities or differences of like organizations during the same time period. *Verifiability* is where a measure, such as an accounting measure, may be repeated with the same result each time. *Timeliness* means that all information needs to be presented or reported in a timely manner to be useful. *Understandability* of information or reports means that the person reading the report—someone who has sufficient experience or knowledge of the business and activities to be able to analyze the data provided in the reports—will be able to understand the information presented. A *trade-off* is a situation where there may be a characteristic that is obtained from the information; however, accomplishing this will come at the expense of eliminating another characteristic. Finally, there is a characteristic called a *cost constraint*. This is where information should only be presented if the benefit of the information outweighs the cost of obtaining the information.

EXHIBIT 1-1 TRAITS OF USEFUL INFORMATION

- Usefulness for decision making
- Relevance
- Faithful representation
- Comparability
- Verifiability
- Timeliness
- Understandability
- Trade-offs
- Cost constraint

Recognition and Measurement in Financial Statements

Financial statements are considered to be the principal means of communicating useful financial information. The data that are included cover the financial position of the organization at the end of the period, the earnings of the period, overall income for the period, the cash flows during the period, and the investments by and distributions to the owners (Flood, 2014d, p. 21).

Financial statements are a result of taking transactions of the organization, simplifying and condensing them, and aggregating them, into one financial report. A financial report or statement of financial position can provide information about an organization's **assets**, liabilities, and equity. An effective measure of an organization's performance during a period is when, at the end of the period, there are earnings that are realized. *Earnings* are similar to *net income* but do not include any accounting adjustments. Comprehensive income takes into account all changes in equity outside of any investments or distributions involving the owners. A statement of cash flows reflects payments made to the company in cash that are derived from operations, financing, and any investment activities. Any investments by the owners or distributions to the owners during the period will be considered capital transactions during the same period.

Income, or a profit, is when the money amount increases during a period. This includes all sales transactions collections during a period; if this value is greater than the expenses of the period and the net assets have increased, then there is a profit.

Elements of Financial Statements

The following are some of the elements that comprise various financial statements:

- Assets–as a result of past transactions, a positive economic benefit is realized by the organization, such as an increase in accounts receivable, cash, or inventory.
- Liabilities–as a result of a past transaction, a negative economic benefit is realized by the organization, such as accounts payable, loans payable, and variable expenses.
- Equity–this amount is what is left in an asset after removing any liability from its value. For example, in a **partnership** equity is considered to be the owner's interest.
- **Revenues**–this is where an organization increases accounts receivable or cash in exchange for products or services provided by the organization.
- Expenses–these are items that are satisfied by the discharge of assets, such as cash, to the organization or entity that supplied the items to the company.
- **Gains**–are increases in equity, or net assets, from the process of completing transactions to external customers.
- **Losses**–are a negative impact on an owner's equity in the organization. In addition, this is defined by situations where the liabilities are greater than the increases in assets during a period.
- Event–the use of raw materials by a company to be provided to a customer and in exchange is made.
- **Transaction**–is an external event that involves transferring something of value such as services or products to another company and in exchange the company will receive payment.

Financial Organizations

There are three types of organizations that will be discussed here: sole proprietorships, partnerships, and corporations. Organizations will be structured based on their financing, leadership, and tax status. In addition, two characteristics that define the type of organizations are for-profit organizations and not-for-profit organizations.

The first type of organization is a **sole proprietorship**. This type of organization it consists of one person who owns the company. The owner may be considered a proprietor who leads the organization and is responsible for all aspects of managing this business. All revenues are realized by the owner on his or her individual tax return. The structure of the organization can change with regards to adding consultants, independent contractors, or employees.

The next type of organization is a **partnership**. This is where two or more people get together to form what would be considered a partnership. The partners will share duties and responsibilities for running the company, and all revenues will be distributed to the partners, who will pay taxes on the money through the reporting of their individual tax returns. In some cases, the partnership can be required to file its own tax return that will show in detail the income distributed to the partners of the company. If there is any change in ownership, it will dissolve the original partnership that was formed.

Finally, a **corporation** is a legal entity that exists separately from the owners. A corporation will pay its own taxes and is subject to its own legal rights and responsibilities (LaTour & Eichenwald Maki, 2014b, p. 767). In this situation, the owners of a corporation can operate as not having anything to do with the day-to-day operations or have different levels of responsibility. The corporation may be governed by a board of directors or trustees. The administrator, CEO, or president will report directly to the board of directors. If there is money left over at the end of the period or year, this income can be distributed to the shareholders or held for future projects. The corporation's income is taxed and then when there are distributions to shareholders, they are taxed at a personal level. This is considered a two-tiered taxation occurrence or double taxation and can make this type of structure less appealing to individuals.

The status of sole proprietorships, partnerships, or corporations can be categorized as either a for-profit or not-for-profit entity. For-profit is where the organization realizes the profit after all obligations have been discharged, from accounts payable to taxes. These profits will increase the wealth of the owners or the company itself, as the profits can be distributed to the shareholders or held onto for future projects. A for-profit company can be held privately or publicly with regards to ownership. In a private ownership, the owner(s) can be an individual or group of people that join together to form the organization. In a public organization, the ownership of the company can be bought or sold on the open stock market. In a publicly held company, the board of directors will be the deciding factor on the distribution of profits and satisfaction of liabilities such as mortgages.

Not-for-profit organizations are held in trust rather than owned as in the for-profit-organizations. There are many hospitals that fit into this tax status. There are also other organizations that fall into this category, such as professional associations like the American Red Cross. To set these organizations apart, the IRS has established two categories for not-for-profit organizations: 501(c)(6) and 501(c)(3).

The 501(c)(6) consists of professional organizations that may buy and sell goods and services but are doing so with the intent of benefiting a major interest group. These organizations are subject to state sales tax.

The 501(c)(3) organizations are, for the most part, exempt from federal taxes. However, they must limit their activities to those that are in the public interest. Any donations to this type of organization will be tax deductible for the person making the donation. Charities or charitable components make up the vast majority of organizations in this category.

EXHIBIT 1-2 TYPES OF ORGANIZATIONS

For-Profit Organizations
- Sole proprietor
- Partnership
- Corporation

Not-For-Profit Organizations – Voluntary
- Church-related
- Private schools
- Foundations

Not-For-Profit – Government
- Federal
- State
- County
- City
- Hospital
- State universities

Sources of Financial Data

Transactions in a Healthcare Facility

Typically there are three vital components that comprise the financial transactions: goods or services are provided, a transaction is recorded, and compensation is exchanged (LaTour & Eichenwald Maki, 2014c, p. 768).

In a healthcare setting, there are many services that are performed and four areas that are of particular importance, the first of which is clinical services. This is where all clinical documentation is completed, and these services, as long as they are documented, will assist the facility in validating that the services were actually rendered to the patient. This clinical documentation will show who was in contact with the patient, what services were delivered, and any other clinical information that can help in the decision-making process for the patient while he or she is in the facility.

The next area is the patient accounts department, which is responsible for gathering all the transactions that are recorded in the patient account through the charge master, producing a bill for the payer, and sending it to them either on paper or via electronic transmission. The overall success of this department is predicated on how accurate the charge description master is and the accuracy of the clinical staff who are recording the transactions in the patient's account.

Health Information Management is the next area. This department is fully responsible for the soft coding of the inpatient medical records. This soft coding process is where the Coding Department, which consists of coding professionals who usually carry the credential of Certified Coding Specialists (CCS), assign diagnosis codes, procedure codes, and query the physician with any questions regarding documentation of the patient's illness and treatment. Once complete, the chart is finalized, and the bill is dropped and sent to the Patient Accounts Department for processing to the payer.

Administration is the last area that we are going to look at for financial transactions. These transactions take place throughout the facility and include employee compensation, purchasing of equipment and supplies, and services performed by some departments for other departments. At this level, the entire management team will review all transactions for the entire facility that impact the financials in the clinical and support areas.

Uses of Financial Data

Reimbursement

A healthcare facility will realize most of their revenue, or income, from clinical activities that surround patient care. So the key here is to track all financial data and make sure that it is accurate, timely, and documented. Typically, a good Revenue Cycle

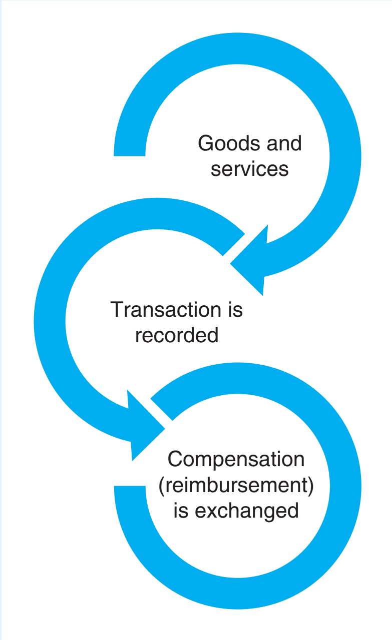

FIGURE 1.1 Components of a healthcare transaction.

Management Team will put a process in place to ensure timely capturing of all data necessary to support the charges to the various payers.

Cost Control

The idea of cost control is best suited at the individual department level. There are many layers in a healthcare facility, and attempting to manage costs across the various departments would create room for error. When the costs are controlled at the individual department level, it makes it possible to manage costs more effectively since the costs are generally associated closely with the day-to-day flow of patient activity.

Planning and Forecasting

Planning and forecasting fall in the administrative area of the facility. **Planning** is something that reflects what the organization is going to do based on its mission statement. In the mission statement are goals and objectives that support the vision of the organization and how it will service the population for which it was established. Planning is an excellent tool for the healthcare administrator; however, this can't be effectively done on historical data alone. This is due to the constant industry changes that have been occurring and will continue to occur as time goes on. With that said,

FIGURE 1.2 Use of financial data.

healthcare administrators will need to plan multiple scenarios in the future and track them with current results and make the necessary changes to the plan to reflect the changing environment going forward.

Forecasting goes hand in hand with planning, as this too looks at future trends based on historical data. Organizations can predict revenues, profits, costs, staffing levels, profitability of contracts over the life of the agreement, and can also predict things like consumer behavior with the use of predictive models that will give the healthcare administrator the ability to look forward based on historical results to stay ahead in this prospective environment.

Conclusion

Although health care seems to be as simple as providing a service and getting paid for it, this chapter demonstrates that there are many components that go into the generating of the financial statements that support the results of the organization's efforts. Not only are there different categories of organizations, such as for-profit and not-for-profit, there are also different types of organizations such as a sole proprietorship, partnership, and a corporation where the accounting and financial functions are governed by different authorities. In the healthcare arena, organizations are overseen by the Federal Accounting Standards Advisory Board and operate under Generally Accepted Accounting Principles. This structure is a result of Title XVIII of the Social Security Act that provided health insurance and supplementary medical insurance for those beneficiaries who are

65 and older or have certain disabilities that would make them eligible for Medicare. The financial components of a healthcare organization are defined by the financial data and transactions that take place in the day-to-day operations. The result of the transactions come in the form or reimbursement, or lack thereof, for services rendered to the patients they serve. These reimbursements, along with the costs of operating a facility, make up the different financial statements that help to guide the decision-making process for the organization. These financial statements consist of assets, liabilities, equity, revenues, expenses, and profit or loss.

This chapter provides the student, or future healthcare administrator, with an introduction to the concepts and principles of the basics with regards to accounting and the information related to the sources and uses of financial data. A good understanding of financial statements is a foundation for the successful evaluation and use of the financial data within the healthcare organization that will enhance the overall foundation of the financial role of the healthcare administrator in this constantly changing and challenging environment.

References

Casto, A.B., & Layman, E. (2013a). *Principles of healthcare reimbursement* (4th ed.). Chicago: AHIMA.

Centers for Medicare and Medicaid Services. (2012, June 1a). *Medicare benefit policy manual: Coverage of hospice services under hospital insurance* (p. 3). Retrieved from http://www.cms.gov/Regulations-and-Guidance/Guidance/Manuals/Downloads/bp102c09.pdf

Cleverley, W., & Cameron, A. (2012). *Essentials of health care finance* (7th ed.). Sudbury, MA: Jones & Bartlett Learning.

Federal Accounting Standards Advisory Board. (2014). Our mission. Retrieved from http://www.fasab.gov/about/mission-objectives/

Flood, M. J. (2014a). *GAAP 2014: Interpretation and application of generally accepted accounting principles*. Somerset, NJ: Wiley.

Flood, M. J. (2014b). *GAAP 2014: Interpretation and application of generally accepted accounting principles*. Somerset, NJ: Wiley.

Flood, M. J. (2014c). *GAAP 2014: Interpretation and application of generally accepted accounting principles*. Somerset, NJ: Wiley.

Flood, M. J. (2014d). *GAAP 2014: Interpretation and application of generally accepted accounting principles*. Somerset, NJ: Wiley.

Klees, B. S. (2009a). Brief summaries of Medicare & Medicaid: Title XVIII and Title XIX of The Social Security Act. (p 6). Retrieved from http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/MedicareProgramRatesStats/downloads/MedicareMedicaidSummaries2009.pdf

LaTour, K.M., & Eichenwald Maki, S. (2013a). *Health information management: Concepts, principles, and practice* (4th ed.). Chicago: AHIMA.

LaTour, K.M., & Eichenwald Maki, S. (2013b). *Health information management: Concepts, principles, and practice* (4th ed.). Chicago: AHIMA.

LaTour, K.M., & Eichenwald Maki, S. (2013b). *Health information management: Concepts, principles, and practice* (4th ed.). Chicago: AHIMA.

Securities and Exchange Commission. (2014a). Retrieved from http://www.sec.gov/about/whatwedo.shtml

Securities and Exchange Commission. (2014b). Retrieved from http://www.sec.gov/about/whatwedo.shtml

United States Treasury. (2014). Internal Revenue Service: The agency, its mission and statutory authority. Retrieved from http://www.irs.gov/uac/The-Agency,-its-Mission-and-Statutory-Authority