

CHAPTER 1

Introduction to Health Care Accounting and Financial Management

DO I REALLY NEED TO UNDERSTAND ACCOUNTING TO BE AN EFFECTIVE HEALTH CARE MANAGER?

Today's health care system, with its many types of health care organizations, is extremely complex. The science of health care, the physical maintenance of facilities, and the interactions and human behaviors within the organizations are complex, as are the financial and accounting requirements. The complexity of today's environment has resulted in the spread of accounting and financial management to all areas within a health care organization. Accounting and financial management are no longer the sole purview of the finance department. Nurse-managers are held responsible for the financial management of their units; pharmacy directors are making significant financial management decisions on a daily basis; and operating room (OR) managers must maintain efficient utilization rates, as well as keeping patients flowing through the OR, to maintain the financial health of the organization.

To be successful, health care managers and executives, regardless of the specific area within a health care organization they lead, must all have a firm understanding of accounting and financial management.

It is clear that not everyone will become the chief financial officer, but everyone is making financial decisions and needs to be able to communicate effectively with financial managers.

WHAT IS FINANCIAL MANAGEMENT?

This book focuses on health care accounting and finance (**Figure 1-1**). *Accounting* is a system for providing financial information. It is generally broken down into two principal elements: financial accounting and managerial accounting. *Finance* has traditionally been thought of as the area of financial management that supervises the acquisition and disposition of the organization's resources, especially cash.

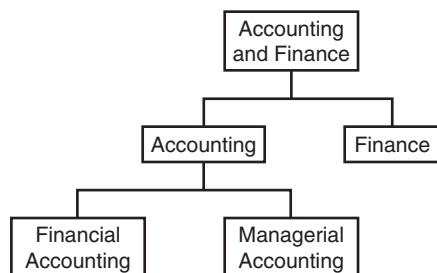


Figure 1-1 Accounting and Finance

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The *financial accounting* aspect of accounting is a formalized system designed to record the financial history of the health care organization. The financial accountant is simply a historian who uses dollar signs. An integral part of the financial accountant's job is to report the organization's history from time to time to interested individuals, usually through the organization's quarterly and annual reports.

The *managerial accountant* looks forward; the financial accountant looks backward. Instead of reporting on what has happened, the managerial accountant provides financial information that might be used for making improved decisions regarding the future. In many organizations the same individual is responsible for providing both financial and managerial accounting information.

The role of finance has expanded significantly from the functions of borrowing funds and investing excess cash resources of the firm. In its broader sense, the finance function involves providing financial analyses to improve decisions that affect the wealth of the organization. Whereas the managerial accountant provides the information for use in the analyses, the finance officer often performs the actual analyses.

WHAT ARE THE GOALS OF FINANCIAL MANAGEMENT WITHIN HEALTH CARE ORGANIZATIONS?

At first, one might say that the goal of financial management is to aid in the maximization of wealth, or more simply, the maximization of the organization's profits. Profits are, after all, literally, the bottom line. However, the health care environment has many other goals—for example, improving the health and well-being of the community, providing the highest quality health care

services, and minimizing morbidity and mortality. For many health care organizations (e.g., not-for-profit hospitals), maximization of profit may not be a goal at all, although at least some profit is usually necessary to ensure the financial well-being of even these organizations.

On a more personal level, managers are concerned with maximization of salaries and benefits. In a for-profit organization, such maximization is often tied in with the maximization of return on investments (ROI), return on equity (ROE), return on assets (ROA), or return on net assets (RONA; see Chapter 14). The list of goals within the organization is relatively endless.

From the perspective of financial management, there are two overriding goals: profitability and viability (**Figure 1-2**). The organization wants to be profitable, and it wants to continue doing business. It is possible to be profitable, yet fail to be able to continue in business. Both goals require some clarification and additional discussion, because these goals surface throughout this book.

Profitability

As stated, many health care organizations do not have maximization of profit as a goal, but even those organizations must generate some level of profit to achieve their other goals. Whether for-profit or not-for-profit, health care organizations need profits to invest in expansion of services so there is wider access to health care. They also need

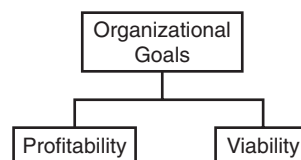


Figure 1-2 Organizational Goals

to earn profits on some patients in order to subsidize those patients who are unable to bear the costs of their services. Health care organizations need profits to acquire new technologies to improve the quality of health care. Further, health care organizations need to earn profits in order to have money available should an emergency arise. Finally, profits are needed so that health care organizations can replace old buildings and equipment as they wear out. Replacement facilities are often more expensive than those they replace, due to inflation if nothing else, and profits are used to cover some of those higher costs. For this reason, we use the terms *profit* and *profitability*, even when referring to not-for-profit health care organizations.

This does not mean that profits are the only goal. They are not even always the primary goal. High-quality health care often comes first. However, we must always bear in mind that profits are necessary to achieve the goals related to providing high-quality care.

In maximizing profits, there is always a trade-off with risk (**Figure 1-3**). The greater the risk we must incur, the greater the anticipated profit or return on our money we demand. Certainly, given two equally risky projects that provide similar health benefits to the community, we would always choose to undertake one with a greater anticipated return. More often than not, however, our situation centers on whether the return on a specific investment is great enough to justify the risk involved.

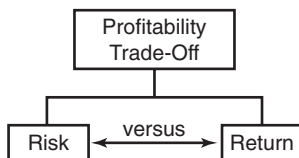


Figure 1-3 Profitability Trade-Off

Consider keeping funds in a passbook account insured by the Federal Deposit Insurance Corporation (FDIC). You might earn a profit or return (in nominal terms—we’ll talk about inflation later) of less than 2%. This return is low, but so is the risk. Alternatively, you could put your money in a nonbank money market fund where the return might be considerably higher. However, the FDIC would not insure the investment, increasing the risk. Or you could put your money in the stock market. In general, do we expect our stocks to do better or worse than a money market fund? Well, the risks inherent in the stock market are significantly higher than in a money market fund. If the expected return were not higher, would anyone invest in the stock market?

This does not mean that everyone chooses to accept the same level of risk. Some people keep all their money in bank accounts; others choose the most speculative of stocks. Some organizations are more willing than others to accept a high risk to achieve a high potential profit. The key here is that, in numerous business decisions, the organization is faced with a trade-off—risk versus return. Throughout this book, when decisions are considered, the question that arises is, “Are the extra profits worth the risk?” It is, we hope, a question you will be more comfortable answering before reaching the end of this book.

As noted, profits are not the sole reason health care organizations exist. Sometimes, profits are just a means to an end and not an end in itself at all. Health care organizations should always make decisions that keep their underlying mission in mind. Throughout this book, we provide many techniques to help you make the best financial decision, other things being equal. We realize, however, that other things are not always equal.

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If two projects yield the same health benefit, the one with greater profits or lower risk is usually the better choice. However, if the health care benefits are not equal, then managers need to factor that into their decision-making process. Sometimes you may decide that you are willing to accept a lower profit or to take a bigger risk to, hopefully, achieve better health outcomes.

Viability

Health care organizations have no desire to go bankrupt, so it is no surprise that one of the crucial goals of financial management is ensuring financial viability. This goal is often measured in terms of *liquidity* and *solvency*. (Figure 1-4)

Liquidity is a measure of the amount of resources an organization has that are cash, or are convertible to cash in the near-term, to meet the obligations the organization has that are coming due in the near-term. Accountants use “near-term,” “short-term,” and “current” interchangeably. Generally, the near-term means 1 year or less. Thus, an organization is liquid if it has enough near-term resources to meet its near-term obligations as they become due for payment.

Solvency is the same concept as viability, but from a long-term perspective, where long-term means more than 1 year. Will the organization have enough cash generation potential over the next 3, 5, and 10 years to meet the major cash needs that will occur over those periods? An organization must plan for adequate solvency well in advance

because the potentially large amounts of cash involved may take a long period to generate. The roots of liquidity crises that put organizations out of business are often buried in inadequate long-term solvency planning in earlier years.

So, a good strategy is maximization of your organization’s liquidity and solvency, right? Wrong. Managers have a complex problem with respect to liquidity. Every dollar kept in liquid form, such as cash, T-bills, or money market funds, is a dollar that could have been invested by the organization in some longer term, higher yielding project or investment. There is a trade-off in the area of viability and profitability. The more profitable the manager attempts to make the organization, by keeping it fully invested, the lower the liquidity and the greater the possibility of a liquidity crisis and even bankruptcy. The more liquid the organization is kept, the lower the profits. This is essentially a special case of the trade-off between risk and return previously discussed.

Similarly, there is a trade-off between providing health care services and viability. Health care organizations cannot always provide all the health care services that patients might want regardless of their ability to pay. Although providing charity care is often appropriate, there must be limits. If the organization decides to provide unlimited charity care without consideration of the financial implications, that might threaten its viability or continued existence.

Health care organizations have to temper the desire to provide health care services, regardless of ability to pay, with the desire to continue doing business. It does not do the community any good for a health care provider to provide so much charity care in 1 year that it goes bankrupt and ceases operations. It is better to provide a measured amount of charity care so the provider can remain viable. That way, the provider can

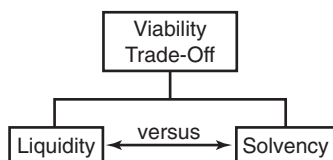


Figure 1-4 Viability

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continue to serve the community, including the poor, on a long-term basis.

We mentioned that profitability and viability are conceptually similar but not synonymous. An organization can be profitable every year, yet go bankrupt anyway. How can this happen? Frequently, this is the result of rapid growth and poor financial planning. Consider a privately held medical supplies company, Expanding Medical Supplies, whose sales are so good that it constantly needs to expand its inventory on hand. Such expansion requires cash payments to manufacturers well in advance of ultimate cash receipts from customers.

Assume that Expanding Medical Supplies starts the year with \$40,000 in cash, \$80,000 of *receivables* (i.e., amounts customers owe Expanding for goods and services, which they have not yet paid), and 10,000 units of inventory. Its inventory units (the medical supply items) are sold for \$10 each, and they have a cost of \$8, yielding a profit of \$2 on each unit sold. During January, Expanding Medical Supplies collects all the receivables that were owed to it at the start of the year (no bad debts!), thus, increasing available cash to \$120,000. January sales are 10,000 units, up 2,000 from the 8,000 units sold in December.

Due to increased sales, Expanding Medical Supplies decides to expand inventory to 12,000 units. Of the \$120,000 available, it spends \$96,000 on replacement and expansion of inventory (12,000 units acquired at \$8 each). No cash is collected yet for sales made in January. This leaves a January month-end cash balance of \$24,000.

\$ 40,000	Cash, January 1
+ 80,000	Plus collections during January
\$ 120,000	Cash available
- 96,000	Less payments for inventory
<u>\$ 24,000</u>	Cash balance, January 31

During February, all \$100,000 of receivables from January's sales (10,000 units at \$10 each) are collected, increasing the available cash to \$124,000. In February, the entire 12,000 units on hand are sold and are replaced in stock, with an expanded total inventory of 15,000 units.

\$ 24,000	Cash, January 31
	Plus collections during
+ 100,000	February
\$ 124,000	Cash available
	Less payments for inventory
- 120,000	(15,000 units at \$8 each)
<u>\$ 4,000</u>	Cash balance, February 28

Everyone at Expanding Medical Supplies is overjoyed. They are making \$2 on each unit sold and are collecting 100% of their sales on a timely basis. There appears to be unlimited growth potential for increasing sales and profits. The reader may suspect that we are going to pull the rug out from under Expanding Medical Supplies by having sales drop or customers stop paying, but that is not the case.

In March, Expanding Medical Supplies collects \$120,000 from its February sales. This is added to the \$4,000 cash balance from the end of February, for an available cash balance of \$124,000 in March. During March, all 15,000 units of inventory are sold, and inventory is replaced and expanded to 20,000 units. Times have never been better, except for one problem: Expanding Medical Supplies has only \$124,000 in cash, but the bill for its March purchases is \$160,000 (20,000 units at \$8 each). It is \$36,000 short in terms of cash needed to meet current needs. Depending on its supplier and its banker, Expanding Medical Supplies may be bankrupt.

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\$ 4,000	Cash, February 28
+ 120,000	Plus collections during March
<u>\$ 124,000</u>	Cash available
	Less payments for inventory
- 160,000	(20,000 units at \$8 each)
<u>\$ (36,000)</u>	Cash balance, March 31

Two key factors make this kind of scenario common: The first is that growth implies outlay of substantial amounts of cash for the increased inventory levels needed to handle growing sales volume. The second is that growth is often accompanied by expansion of plant and equipment, again, well in advance of the ultimate receipt of cash from customers.

Do growing organizations have to go bankrupt? Obviously not, but they do need to plan their liquidity and solvency, along with their growth. The key is to focus on long-term plans for cash. It is often said that banks prefer to lend to those who don't need the money. Certainly, banks do not like to lend to organizations, such as Expanding Medical Supplies, who are desperate for the money. A more sensible approach for Expanding Medical Supplies than going to a bank in March would be to lay out a long-term plan for how much it expects to grow and what the cash needs are for that amount of growth. The money can then be obtained by issuing bonds and additional shares of stock (see Chapter 17), or orderly bank financing can be anticipated and approved well in advance.

Apparently, even in a profitable environment, cash flow projections are a real concern. Liquidity and solvency are crucial to an organization's viability. Therefore, throughout the book, we return to this issue, as well as that of profitability. In fact, the reader will become aware that a substantial amount of emphasis in financial accounting is placed

on providing the user of financial information with indications of the organization's liquidity and solvency.

HOW DOES ACCOUNTING FIT INTO FINANCIAL MANAGEMENT?

As mentioned, financial accounting is like history with dollar signs, and as with many things in life, we can learn a great deal from history. To that end, financial accounting, often taking the form of balance sheets and income statements, can help managers make ongoing decisions to help the organization maintain both its profitability and viability. In Chapter 3, we introduce the reader to the financial environment of today's health care organizations. There are a number of unique aspects of health care that require a solid understanding before one can start to completely understand accounting and the financial statements that are generated by accountants. Chapter 4 introduces basic accounting concepts used within the broader framework of financial management.

KEY CONCEPTS

Financial management—Management of the finances of the organization to maximize the organization's wealth and the achievement of its other goals.

Accounting—The provision of financial information.

- Financial accounting*—Provision of retrospective information, regarding the financial position of the organization and the results of its operations.
- Managerial accounting*—Provision of prospective financial information for making improved managerial decisions.

Finance—Provision of analyses, concerning the acquisition and disposition of the organization's resources.

Chapter 1: Introduction to Health Care Accounting and Financial Management 7*Goals of Financial Management*

- a. *Profitability*—A trade-off always exists between maximization of expected profits and the acceptable level of risk. Undertaking greater risk requires greater anticipated returns.
- b. *Viability*—A trade-off always exists between viability and profitability. Greater liquidity results in more safety, but lower profits.

TEST YOUR KNOWLEDGE

1. Explain the primary functions of finance.
2. Explain the primary functions of accounting.
3. What are the primary goals of financial management for not-for-profit health care organizations?
4. What are the uses of profit for health care organizations?
5. Explain the relationship between financial risk and financial return.
6. Why doesn't every person or organization invest all available funds into the stock market, which has the highest expected return?
7. What do accountants mean when they say "short-term" and "long-term"?
8. Explain how an organization's liquidity and solvency are related.

