CHAPTER 2

Financial Management

LEARNING OUTCOMES

1. Recognize the importance of the accounting function, reporting, analyzing, and planning for the nonfinancial manager.
2. Understand the differences between financial accounting and managerial accounting for the nonfinancial manager.
3. Interpret financial reports, such as income statements, cash flow statements, and balance sheets.
4. Identify and explain the different components of financial statements, such as revenues, expenses, and owner's equity.
5. Understand the impact of net income financial statements and what it means to the organization with regard to the planning and budgeting process.
6. Explain the use of the general ledger in the financial management process.
7. Identify, interpret, and respond to variances in the financial reporting process in both the immediate and long-range planning process of an organization.
8. Classify the different costs, both direct and indirect, of an organization and the proper allocation of these costs throughout the organization.
9. Compile the necessary data to calculate and analyze the basic financial ratios for an organization.
10. Categorize the revenues and expenses of an organization to effectively select and construct the appropriate type of budget for the organization.

Introduction

This chapter is geared toward assisting the healthcare manager with some level of accounting background, either basic or somewhat more advanced through experience or education, to better understand the tools that come along with the financial reporting side of the operation. This chapter will introduce the student to the difference between healthcare accounting and non-healthcare accounting and then address financial accounting and the importance that this has on the organization's decision-making process. Inside these reports reside the main components of the financial report. First are assets, which are things or items that are owned by the company and that have value. Second are liabilities, which represent amounts owed by the company for services or items purchased to run the daily operations or help build what the company sells to their clients. Third are revenues or income that the company generates to increase cash and accounts receivable by selling an item or service to another company that will increase cash or accounts receivable.

Fourth is owner's equity, which represents the difference between the assets that the company has accumulated and liabilities, or bills, that the company has incurred as a result of generating sales for the company. This chapter will also explore general ledger and journal entries that help to track and categorize various revenues and expenses into similar groups and accounts.

The next part of the chapter will focus on budgets and financial statements. These two tools are frequently used in making short-term and long-term decisions for the company. The different types of budgets, such as fixed or flexible, and the variances that occur during the budget period will help to guide the company on the path, or plan, that the management team has outlined in their strategic planning. The financial statements will identify, in real time, where the organization is performing at a variety of levels.

Inside these financial statements are tools that measure information in a snapshot or over a defined period. You will see that this information can be used to develop key indicators, or ratios, that help to identify current trends with a short-term approach. These indicators, or ratios, will assist the managerial staff in assessing and developing various strategies to keep the company moving in the right direction. Finally, this chapter will cover managerial accounting and the purposes for the reporting, current versus future, and the necessary levels of consistency that come along with managerial accounting.

Financial Accounting

Financial accounting is defined as "the branch of accounting that provides general-purpose financial statements or reports to aid many decision-making groups, internal and external to the organization, in making a variety of decisions" (Cleverley & Cleverley, 2018, p. 196). Four main reports are considered outputs of financial accounting: the balance sheet, the statement of operations, the statement of cash flows, and the statement of changes in net assets. These four statements are not the only statements that are produced in financial accounting, as there are also reports required for decision-making purposes, such as cost reports and financial projections. All of the reports are utilized based on the reporting needs of the industry and the information available to create the reports. Also, these reports are not generally audited by independent Certified Public Accountants (CPAs) but are created based on Generally Accepted Accounting Principles (GAAP) (**Figure 2.1**).

Differences Between Healthcare Financial Accounting and Other Organizations

Taking a deeper look into accounting, especially for healthcare organizations, the process involves various types of organizations that fall into the healthcare delivery model, such as hospitals, ambulatory care centers, doctor's offices, clinics, home care, nursing homes, long-term care, assisted living, laboratory, durable medical equipment, dental offices, and mental health. At first glance, the accounting process for healthcare organizations is much like other industries as they have balance sheets, cash flow statements, accounts payable, accounts receivable, taxes, and payroll. Healthcare and non-healthcare organizations use CPAs and follow GAAP; however, the similarities stop there because healthcare revenue is generated through patient revenue of many types, and just the idea of patient revenue brings up HIPAA (Health Insurance Portability and Accountability Act). The revenue stream in a healthcare organization can come from direct patient care, indirect patient care, sales, and rentals. Knowing what HIPAA is all about and protected health information (PHI) is only the first step in understanding the differences between healthcare and non-healthcare organizations. The next area is different types of revenue and payments that come from prospective payment systems (PPS) or from fee-for-service. The accounting is very complex in this area since we can see the revenue being generated, but what we don't see is all of the different revenue streams that are part of the overall revenue for the organization.

Figure 2.1 Four Key Reports in Financial Accounting

Revenues are impacted by payer mixes and chargemasters. The payer mix is the different payer types from government payers, commercial payers, or state payers, or self-pay. These payers all may require different billing processes, which can create much confusion in capturing revenue. Then a chargemaster captures the charges automatically and then bills the payer or patient based on payer rules in the system. The chargemaster needs to be accurate and audited on a regular basis because a healthcare system can either underbill or overbill, and both will negatively impact the healthcare organization.

After identifying the different revenue streams and the payer mix for a healthcare organization, then the process of matching up revenue with the associated expenses begins. The accounting function will need to track all expenses and associate them with the patient stay or patient encounter to ensure the ability to determine profitability. Another area of difference is the ability to properly forecast revenues since this process involves the need for predictability models that can help the healthcare organization plan for increases or decreases in revenue. However, even if one plans for the changes in revenue during a year, unlike other non-healthcare industries, healthcare organizations need to properly document patient care in the medical record or electronic health record (EHR), or if not, their reimbursement can be severely compromised. Moreover, experiencing the COVID-19 pandemic was something that could not be planned for as a country let alone a healthcare system. The changes in the delivery model, especially the demand side, were unprecedented, and even more of an issue was the billing and documentation required to achieve proper reimbursement. The accounting functions in a healthcare organization are complex, and the accounting team needs to know the terms, products used, processes for charge capture, and cash flow projections in order to match up revenue and expenses and report them in the proper period.

Decisions made in a healthcare organization can certainly have an impact on patient care. The proper accounting function will allow for the appropriate charge capture and billing procedures,

which allows for proper staffing for patient care, all of which lead the healthcare organization to cost-effective, quality-focused care and quality patient outcomes. Having everything organized in the healthcare system, from accounting, charge capture, billing, and financial reporting measures will allow the administrative, support services, and clinical teams to focus on their part of the patient care experience, knowing that they can put the patient as the center of attention for their care because the financial and clinical documentation processes are able to focus on their areas of the care model.

Assets

An asset is something that is owned by the company. An asset can be in possession of the company, although assets can also be items that are due to be received. An example of this is accounts receivable, where an organization provides a service to a customer, and the customer agrees to pay for the services after they are completed. Some examples of assets are cash, inventory, accounts receivable, buildings, and equipment.

Cash

Cash assets are considered to be cash on hand or items that can be converted into cash quickly and in a short period of time, such as a few days. Items that are included in this category are cash in bank accounts and cash that is part of a wire transfer. An example of a wire transfer, or electronic funds transfer (EFT), is when an insurance company pays a provider for services rendered to one of their members through an EFT. This wire transaction is considered to be the same as if someone walked up to a bank teller and handed over cash for the deposit.

Inventory

Inventory consists of goods that are purchased by an organization and sold to its customers. For a durable medical equipment (DME) company, its inventory is considered to be hospital beds, walkers, canes, commodes, wheelchairs, oxygen tanks, and ventilators. For a pharmacy, its inventory consists of medications, compound items, and blood-derived products, just to name a few. This inventory is considered an asset because it can usually be turned into cash rather easily by selling it to a customer or a vendor for cash, who then may sell it to other customers.

Accounts Receivable

If an organization sells a product or service to a customer who does not pay at the time of delivery, this sale amount is considered to be accounts receivable due to the organization. This revenue is recorded in the organization's financial records as a sale by reducing any inventory that may have been sold and increasing the accounts receivable by the amount of the sale. A simple formula to calculate the receivables of an organization is to take the following:

- Beginning accounts receivable + sales – collections = ending accounts receivable

Buildings

Some organizations own the buildings in which they operate; others will rent or lease buildings from other entities. When a building is purchased, it is considered an asset, as the company either owns it outright or has a mortgage on the building. When a building is leased, it is not considered an asset because the company does not own the building. When a company purchases a building, it often will put a down payment on the building and finance the balance in the form of a mortgage. The difference between the amount owed on the mortgage and the value of the building is considered to be equity.

Equipment

When an organization purchases a piece of equipment for use or resale, the value is recorded in the records as the amount of the purchase price for the equipment. Equipment is considered to be a long-term asset. Some equipment has a lower purchase price, so it is up to the individual organization as to how it records the

equipment. It can be recorded as a long-term asset, where the cost of the equipment is spread out over a few years. Or the equipment is paid for when purchased, and the expense is recorded in the current period such that the entire value paid will be part of the financial reporting for that period.

A piece of equipment has a purchase price, and this number is used to determine the value that is recorded. For example, a DME provider purchases a hospital bed for $1,000 from the manufacturer. Now, the DME company has an asset with a value of $1,000, and this asset can be depreciated based on the individual company's policies. Regardless, at this point, the company has an asset that will have a life of several years (**Figure 2.2**).

With regard to **depreciation**, this is where the company takes the value of the asset and spreads out the cost over a defined period that is consistent with the accounting practices of the company. In the example of the DME company where it purchased a hospital bed for $1,000, the company will now record the asset and take the value of the equipment each year over the expected life of the asset. For example, the hospital bed should last at least 5 years, and the purchase price was $1,000. Now, if the company is taking assets of this value and depreciating it over the 5 years of the expected life of the unit, it will take $200 for each year over the next 5 years as a depreciation expense until it has a zero value.

Liabilities

Liabilities are debts of the company, and these amounts, which are part of the company's liabilities, represent items purchased, services utilized, or money spent purchasing items that turn into inventory for resale. The amount that is due to the company from which the item was purchased will be considered a debt, and the inventory will be recorded as an asset in the company's books.

Accounts Payable

Accounts payable is an amount due to an outside vendor for the purchase of supplies/equipment or services utilized. The recording of accounts payable is considered a liability to the company and will need to be paid to the company that is owed the money. For example, the DME company purchased the hospital bed for $1,000; now, it has the asset, but there is a corresponding liability for the purchase of this bed. The amount of $1,000 due to the vendor is considered to be accounts payable that will be scheduled to be paid based on the terms and conditions of the company from whom it purchased the equipment.

Notes Payable

Notes payable is considered to be a financial obligation that is supported by a contract and has a time frame for repayment. A note may be associated with a large purchase or a loan when an organization uses some of its assets as collateral.

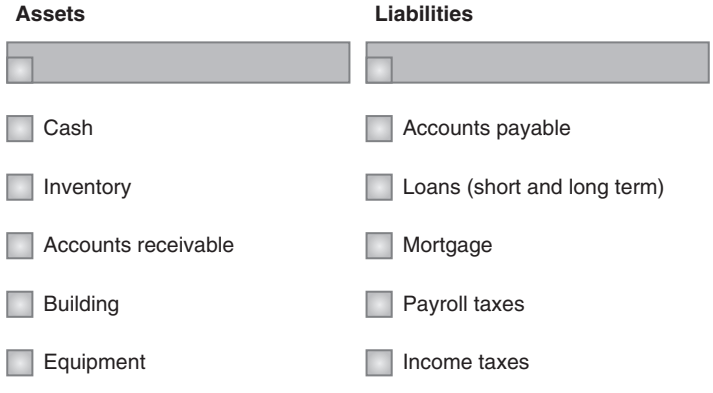

Figure 2.2 Examples of Assets and Liabilities

Net Assets and Equity

The difference between what is owed and assets is considered equity. According to Oachs and Watters (2020), "equity (or owner's equity) is the arithmetic difference between assets and liabilities" (p. 814). Simply put, the equation is as follows:

- Assets – Liabilities = Net Assets (or owner's equity)

Another way of defining this equation is as follows:

- Assets = Liabilities + Net Assets (or owner's equity)

All of these assets, liabilities, and owner's equity are part of the organization's balance sheet. The balance sheet will be discussed later in this chapter.

Revenue

Revenue is the income that is produced through the sales function of an organization, when it sells products or services to customers. The amount that the customers will pay for these products or services will be revenue. In a healthcare facility, the primary source of revenue is driven by patient services, and this can include outpatient services, such as laboratory tests and X-ray, inpatient services, such as surgical and medical care, along with other services, such as OB-GYN, rehabilitation, dialysis, home care, and physician services.

Revenue Categories

The categories of revenue are broken down into operating and nonoperating revenue. An example of operating revenue is patient services revenue, which is generated by daily operations. In contrast, an example of nonoperating revenue would be investment income and the money generated from the gift shop that is run by the volunteer organization in the hospital; both are only indirectly related to daily operations (**Figures 2.3** and **2.4**).

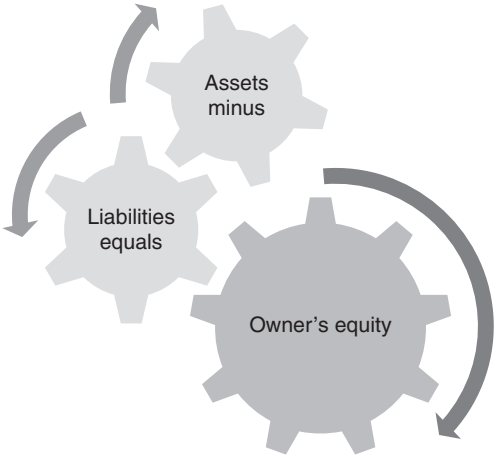

Figure 2.3 Owner's Equity (Net Assets) Formula 1

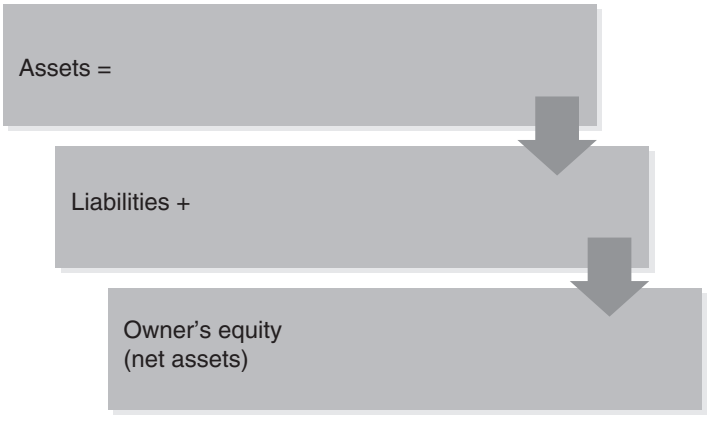

Figure 2.4 Assets Formula 2

Revenue Forecasting

The COVID-19 pandemic had a huge financial and operational impact on the overall healthcare delivery model. The federal government came through with financial assistance to healthcare organizations. According to Congress.gov, the U.S. Congress approved approximately $1.9 trillion dollars for healthcare organizations through the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) (Congress.gov, 2020). However, not a great deal of direct funding was provided to physician practices according to Matt Seefeld's article for the Medical Group Management Association (MGMA) (Seefeld, 2020). Overall, with all of the impacts of COVID-19, the need to forecast the revenue for an organization or a primary care office is more important now than in the past. Once the revenue streams for healthcare organizations were interrupted, the need for forecasting became a priority, much like when an organization is in the start-up mode. Since there can be a delay in closing and dropping bills to the insurance carriers, the healthcare organization will need to factor in the delay in billing and collections. In addition to this process, the healthcare organization will need to ensure clean coding in order to avoid delays in claims processing. All of which have an impact on cash flow. Some of the other areas of concern when forecasting are denial rates, outside of clean claim rate, and patients rescheduling their appointments. By taking into account delays in dropping claims, clean claim rate, denial rate, and rescheduling of appointments, the healthcare organization will be able to develop a forecast of revenue or collections that will help the organization plan better for the future. Keep in mind that the forecast that is developed will need to be constantly checked and adjusted by the current trends and activity taking place in the healthcare revenue cycle. Accurate forecasting of revenue is critical, even outside of COVID-19, because this is a key factor in budgeting and strategic planning moving forward post-COVID-19.

Expenses

Expenses are a result of expending resources to operate the organization on a daily basis that will lead to generating revenues. An expense can be anything from office supplies in the Health Information Department to software expenses in the Information Technology Department that support the day-to-day operations. Tracking and recording the expenses in each department of a healthcare facility will reduce the asset account of cash to relieve the accounts payable. In the long run, if revenue exceeds expenses for a given period, the organization has positive income.

General Ledger

The general ledger is part of the accounting system where all the entries are recorded in chronological order. Once posted to the general ledger, the debits and credits are posted to the individual accounts for that company transaction. The general ledger comprises all of the accounts in the organization. Previously, the general ledger was on paper, but with the evolving technology, most accounting systems are computerized, which allows the reporting to be more streamlined and more readily available for review by the departments and managers. The individual department does not make the entries in the general ledger, but it will sign off on expenses that are related to the individual department and forward them to accounting, so that an invoice can be processed for posting to the general ledger and the particular account, along with processing payment to the vendor for the product or services that the organization purchased.

General ledger accounts constitute another layer of information that will help to ensure that all expenses and revenues are allocated to the correct department. Each department in the organization will have its own department codes, which identify the expenses and revenue accrued to that department. At the end of the month or period, the accounting team can run reports at the department level to show only that department's activity and at the management level to show the facility as a whole. When items in the report are out of line

with the rest of the organization, the manager can look more closely into the accounts to see which department is negatively or positively impacting the overall performance of the organization.

Journal Entry

Each entry for the general ledger will consist of a debit and a credit—and they must balance out. For example, suppose supplies were purchased for $500 from a local vendor. The supplies have arrived, and the vendor has sent an invoice for payment to the organization. The individual department will verify that the items on the invoice were received, and it will approve the invoice for payment. The invoice will be sent to the accounting department for posting and payment. The accounting department will make a debit entry in the general ledger for office supplies expense and a credit for $500 in accounts payable. Then, when the invoice is paid, the entries will be a debit to accounts payable in the amount of $500 and a credit (reduction) for $500 to the cash account. All entries must balance out, in that if you have $500 in debits, you need to have $500 in credits to balance out.

Managerial Accounting

Managerial accounting focuses on the needs of the internal customer or user. Since the information is generally used for internal purposes, it does not come under the same requirements that are expected for external reporting. With this in mind, there still needs to be a level of consistency in the preparation of information delivered to the internal customer. The difference between managerial accounting and financial accounting is that managerial accounting focuses more on the future planning of the organization, whereas financial accounting focuses more on recording transactions that cover historical financial transactions.

Definition of Costs

The utilization of resources in the manufacturing of a product, distribution of a product, or providing services to a customer is critical to the overall management of the operation with regard to managing costs and profitability. The ability of an organization to measure costs throughout the manufacturing and sales cycle is done through the appropriate classification of costs. Moreover, the use of these data, from an internal perspective, will provide a variety of additional data for the management team.

Direct Costs

A direct cost is one that can be traced back to a specific service provided or a product that was manufactured. For example, the pharmacy provides a patient with a medication. This type of transaction can be traced directly back to the patient, as it is associated with patient care. Another direct cost example is where a home care company purchases liquid oxygen to fill portable oxygen tanks for patients to use when outside the home. This cost for a product, such as liquid oxygen, can be captured and associated directly with the tanks that are delivered to the patient each week.

Indirect Costs

An indirect cost is a cost that is incurred in the organization as it provides products or services to a customer, but the cost is not directly related to the manufacturing of goods or services provided by the organization. Some examples of indirect costs in a hospital are security and housekeeping. The payroll cost for security and housekeeping is considered to be indirect, or not related to providing clinical care or services, and these costs are distributed to all the departments that they serve in the hospital. The costs are allocated to the departments through the hospital based on the percentage of revenue a particular department has in comparison with the total revenue of the facility. Alternatively, it can be distributed based on the square footage of a department in relation to the total square footage of the facility (**Figure 2.5**).

Fixed Costs

The costs of a facility can be fixed or variable. The classification of a fixed cost is one that will remain constant and will not be influenced by volume. An example of a fixed cost is a mortgage payment, as it is the same each month for the term of the loan. Another example of a fixed cost is the salary of a manager in a department.

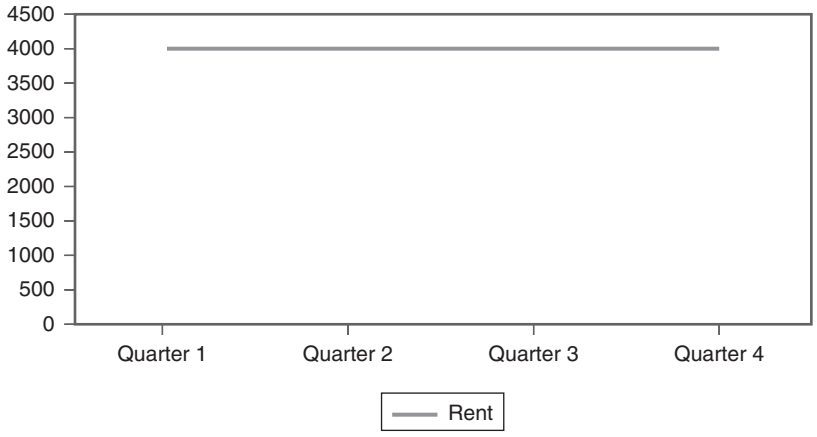

Figure 2.5 Fixed Expenses

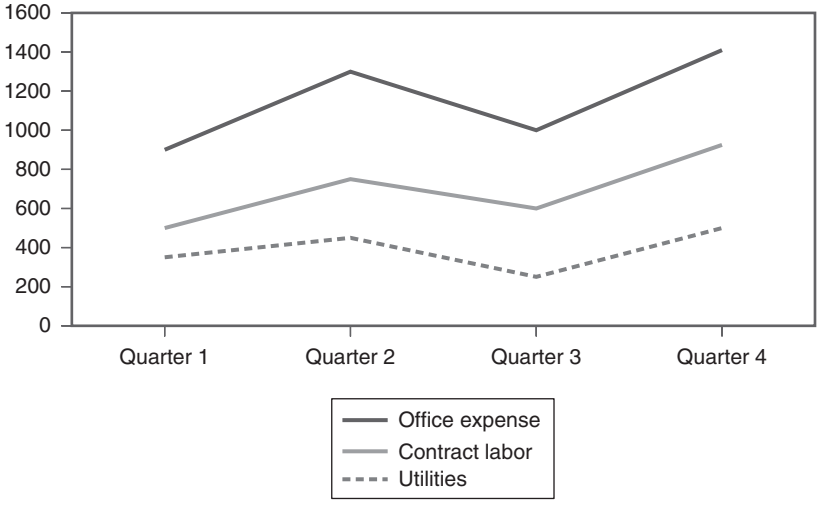

Figure 2.6 Variable Expenses

Regardless of the number of hours this manager works, the salary remains the same.

Variable Costs

Variable costs are influenced by volume and can change each month based on those changes in volume. For example, the Health Information Management (HIM) department uses office supplies to complete their work, such as file folders. If the hospital has only 50% occupancy one month, and then, there is 90% occupancy the next month, the variable cost of file folders will increase based on volume (**Figure 2.6**).

Semifixed Costs

Some costs are impacted by volume but are not extremely sensitive to volume changes. For example, you have a coding staff in the HIM department, and they currently handle 1,800 charts per month, but the capacity of the current staff is 2,000 charts per month. If the hospital increases the number of discharges to 1,950 the next month, the staffing will not need to be adjusted. However, if the hospital increases the number of discharges to 2,250 per month, the department will need to hire another coder or utilize an outside coding service. This makes the coding payroll a semifixed cost

based on the volume that the department realizes, but it is not sensitive to every change in volume.

Allocation of Overhead

As mentioned earlier in the direct and indirect costs for a facility, some costs will need to be allocated to the entire facility. These indirect costs can be distributed using several approaches that include direct method, step-down allocation, double distribution, and simultaneous equations method.

The direct method of allocating costs will distribute the costs involved with overhead to the revenue-producing departments. These costs will be distributed to the individual revenue-generating departments based on a percentage of revenue that they produce compared to the entire facility or the square footage that they occupy in comparison to the entire facility's square footage. For example, the radiology department produces 3% of the facility's total square footage. Therefore, the radiology department will be allocated 3% of the facility's total indirect costs (**Tables 2.1** and **2.2**).

The step-down allocation method is designed to distribute the indirect costs, starting with the department that provides the least amount of revenue-generating services. The next method is double distribution, a process that allocates costs associated with overhead two times such that costs will be distributed to some overhead departments that provide services to each other. Moreover, finally, the simultaneous equations method is one that allocates overhead through multiple scenarios, ensuring the maximum allocation of interdepartmental costs to the overhead of the involved departments.

Budgets

Managers not only oversee the financial reports, but they also manage the process that feeds the financial reporting process—and this starts with the budget. It is critical for a manager to understand basic accounting to properly read financials and check for appropriate allocation of revenue

Table 2.1 Allocation of Indirect Costs by Square Footage

Springfield Medical Center Total Square Footage 250,000 sq. ft.		
Square Footage by Cost Center	**Total**	**Percentage of Allocation (%)**
Dietary	4,500	1.8
Laundry	3,800	1.5
Housekeeping	1,250	0.5
Security	1,000	0.4
HIM	4,950	1.98

Table 2.2 Allocation of Indirect Costs by Revenue

Springfield Medical Center Total Revenue $227,500,000		
Revenue by Department	**Total**	**Percentage of Allocation (%)**
Radiology	$24,500,000	10.76
Laboratory	$8,257,500	3.62
Surgery	$133,250,500	58.57
Home care	$8,000,000	3.51
Emergency department	$36,400,950	16.00

and expenses, but it is equally important to have the ability to forecast revenue and expenses for the department or organization to meet the mission and vision of the organization through the budget process.

Fixed Budget

This type of budget is designed to account for the volume of activity that is expected in the upcoming year based on historical data. The budget will not change during the year even if the volume of business changes over the year. If there are changes in volume, this will create variances that are either positive or negative. For example, if the hospital increases the volume of patients over the year, then the number of discharges that the coding department will have to code increases as well. If the HIM department has to hire another coder to handle the increased volume or increase the number of outside services used, there will be a negative variance, where the budgeted salaries will be lower than the actual salaries paid in the department. For the most part, variances, either positive or negative, that exceed a percentage set by the organization will need to be explained by the manager.

Flexible Budget

A flexible budget is created based on productivity that is projected according to historical data. In the example with the HIM department and the increase in discharges through the year, the department will have a budget based on levels of volume, and the department will need to manage the level of activity and balance this with the actual levels of staffing.

Activity-Based Budget

Based on projects, instead of departments, activity-based budgets are typically used for projects that will run over the course of a year or longer, for example, in construction or for an IT department.

Zero-Based Budget

This type of budget is where an organization will decide to continue or discontinue a service based on each department justifying and prioritizing activities each year. The zero-based budgeting is commonly used in professional associations and charitable foundations.

Budget Cycles

The budget cycle is generally related to the **fiscal year** of a company. The process takes into account the projected revenues generated from sales by the organization and expenses for the organization to manufacture a product or deliver these services. The budget process will start 3–4 months before the next fiscal year, which will give ample time for the management team to gather historical data and forecast the activity for the upcoming fiscal year (**Table 2.3**).

Budget Components

The various components of the budget consist of different types of revenues and expenses that are generated by the organization. The revenue will be any amount that is related to the sale of products or services to customers that are associated with a particular department. The HIM department generates little revenue, so its budget will consist mainly of expenses. The manager will

Table 2.3 Budget Variance

Category	Budget	Actual	Variance	Percentage (%)
Office supplies	$1,500.00	$1,670.00	$170.00	10.2
Outside coding service	$7,500.00	$7,525.00	$25.00	0.4
File room labor	$8,000.00	$7,100.00	($900.00)	(11.25)

need to look at historical costs and trends to come up with a budget that will appropriately reflect the anticipated costs associated with operating the HIM department over the next fiscal year.

Budget Variances

A budget variance is a mathematical difference between what was budgeted and what actually happens. This variance will be the responsibility of the manager to explain and manage. These variances are often calculated by looking at the actual results from the financial reports for the month and comparing them to what was budgeted. Variances are reported on the financial report and can be positive or negative.

A variance can also be classified as a temporary or permanent variance. A temporary variance could be from a department bringing in contract labor to cover summer vacations. This variance will be a temporary because it only happens when staff members take vacations. A permanent variance, in contrast, will not change in the near future or current fiscal year. For example, if the hospital occupancy rate increases due to added services, increasing the HIM department coder's volume, then the department will hire an additional coder to cover the additional volume. This will be considered a permanent variance because it will not change during the current fiscal year.

Explanation of Variances

A variance is something that will need to be explained by the manager supervising the department where the variance occurred. The information that the manager needs to communicate is the nature of the variance—is it temporary or permanent?—the exact dollar amount and percentage of variance, the issue or issues that caused the variance, and any explanations that can justify the variance or show an offset in another area.

The reporting of a variance can be based on the dollar amount of variance or the percentage of variance. Only variances that are of a particular value and impact on the overall performance of the organization need to be explained. A small variance of $100 or a 1% variance may not have an impact on the organization and may not require a detailed explanation. The administrator should look at managing this variance throughout the fiscal period to maintain control of costs over the year. There may be reasons for the variance, such as an increase in contract labor expense for which not enough money was budgeted, which may be balanced by a decrease in payroll for the department related to two vacancies. This offset is useful to explain, but it needs to be managed appropriately; once the positions are filled, the use of contract labor should go back to the budgeted amount.

Capital Budgets

A capital budget is one that looks mainly at large purchases in the upcoming year. These can consist of capital investments, which are of significant value and can be long-term investments. These capital budgets are sometimes associated with capital improvements or expansion of services. This capital budget will direct resources to support the organization's plan that will be over and above the operating budget for the organization.

Financial Statements

Balance Sheet

The statements of financial positions, otherwise known as the balance sheet, display information about the organization's assets and owner's equity along with the financing structure of liabilities and equity in accordance with GAAP. The balance sheet shows, at a certain point in time, the impact that all of the organization's transactions have had on the company's assets, liabilities, and owner's equity (Flood, 2022, p. 40).

In addition, the report looks at the following items to assess the financial position of the organization, including liquidity of the organization or the level of cash in the operating system, financial flexibility or the organization's ability to respond to unexpected turns in the financial position of the operations, the organization's ability to pay its debts when they are due, and the ability to distribute cash to the owners or the shareholders.

The report also breaks up the assets into current assets, such as cash and accounts receivables, and long-term assets, such as buildings and equipment. The liabilities are also treated the same way, in that there are current liabilities, such as accounts payable, and long-term liabilities, such as notes or mortgages. The calculation of assets minus liabilities determines owner's equity. If the owner's equity is positive, then the organization is somewhat liquid, but if the owner's equity account is negative, then the organization is not as liquid and may lack the working capital to handle any unexpected event that could impact it (**Exhibit 2.1**).

Exhibit 2.1 Balance Sheet

Springfield Medical Center
Balance Sheet
as of December 31, 2023

Assets	
Current Assets	
Cash	$165,000
Accounts receivable	$725,000
Inventory	$87,500
Total current assets	$977,500
Property, Plant, and Equipment	
Land	$85,000
Building	$2,500,000
Equipment	$450,000
Total property, plant, and equipment	$3,035,000
Total assets	$4,012,500
Liabilities	
Current Liabilities	
Accounts payable	$287,500
Other	$56,000
Total current liabilities	$287,500
Long-Term Debt	
Mortgage	$2,400,000
Total liabilities	$2,687,500
Fund Balance	
Restricted funds	$0
Unrestricted funds	$1,325,000
Total fund balance	$1,325,000
Total liabilities and fund balance	$4,012,500

Exhibit 2.2 **Statement of Revenue and Expenses**

Springfield Medical Center
Statement of Revenue and Expenses

Revenues	***12/31/2022***	***12/31/2023***
Net patient services revenue	$8,300,000	$9,250,000
Total operating revenue	$4,300,000	$5,015,000
Operating Expenses		
Med/surg services	$2,450,000	$2,750,000
Home care services	$845,000	$917,000
Infusion services	$218,000	$245,000
Support services	$78,000	$86,500
Depreciation	$32,000	$32,000
Interest	$15,000	$18,000
Total operating expenses	$3,638,000	$4,048,500
Income from operations	$662,000	$966,500
Interest income	$3200	$4000
Nonoperating gains	$3200	$4000
Increase in unrestricted fund balance	$665,200	$970,500

Income Statement

The income statement is also known as the profit and loss statement. The profit and loss statement is intended to demonstrate how much money a company is making or losing, and it accomplishes this "by subtracting all of the costs of production of goods that have been sold during the period and other expenses of running the company from the revenues generated from sales of products or from services provided" (Bandler, 1994, p. 34).

The statement consists of revenues, which represent actual or expected cash inflows that result from an organization's operations. According to GAAP, "revenues are generally recognized at the culmination of the earnings process—when the entity has substantially completed all it must do to be entitled to future cash inflows" (Flood, 2022, p. 71). For the most part, once a transaction has been completed, the organization has realized revenues that have been earned (**Exhibit 2.2**).

Cost of Goods Sold and Gross Profit

Cost of goods are "all costs allocated to inventory sold during the period, including labor, materials, and overhead" (Bandler, 1994, p. 35). For a hospital, cost of goods can consist of supplies, equipment, salaries, and other overhead.

The difference between the sales of an organization and the cost of goods sold will be the gross profit. This amount is referred to as gross profit because other expenses still need to be factored into the operations to come to the net profit of a particular period for the organization. The net profit, or net income, is the amount of money that is left over after all revenues are accounted for and all expenses, or costs of doing business in that

time period, are deducted from the revenue; the difference (positive or negative) is the net income for the organization.

The profits or losses are added to the balance sheet in the owner's equity account. The impact on the balance sheet is that when there is a profit, the owner's equity account is increased by that amount. When the organization realizes a loss, the owner's equity account is impacted in a negative way.

Cash Flow Statement

The statement of cash flows "is a required part of a complete set of financial statements for business enterprises and not-for-profit organizations" (Flood, 2022, p. 67). The primary function of the cash flow statement is to provide the organization with the amount of cash receipts during a particular period. Another purpose for this statement is to identify the investing and financing activity during the statement period. The cash flow statement will only track cash in and cash out, including cash equivalents, such as investments that are considered to be liquid, or quickly turned into cash.

The cash flow statement will help the organization to determine its ability to generate positive cash flows in the future, to meet the organization's obligations with regard to payments for accounts payable and distributions to shareholders or owners, to identify variances in net income and cash in and cash out, and to assess the impact of investing and financing on the organization's financial position.

Who Uses Financial Statements?

Financial statements can be viewed as dull and uninviting documents that can induce long naps at work or the occasional mental vacation where one is looking at a piece of paper but is actually visualizing a perfect beach before coming back to reality. Financial statements can be very intriguing if one can just get to know their value, and the financial picture that they can paint will be much more interesting than the perfect beach that one can dream up while at work.

The financial reports tell a story of every employee and vendor, sales representative and customer, and every regulatory agent and surveyor's impact on the financial picture of the company. These reports allow you to look into the future and forecast what it may be like in 30, 60, 90, or 120 days—or for that matter, a year or two from the present time. By using historical data, a manager can easily take the reports and extrapolate data that can show the organization's trends for growth, or lack of growth, over a specified period. Once the healthcare manager experiences the power of a financial report and the forward vision it provides to both the manager and the organization as a whole, the manager will use these reports on a regular basis.

Now, for the owners of a company, financial reports are critical to them because they need to report to the bank or lenders on the financial position of their company. If they are using the accounts receivable for leverage or collateral for a line of credit, the balance sheet and income statement are vital in painting a complete and timely picture of where the company is and where it is going. The balance sheet is used to see the owner's equity in the company, and it is used to calculate ratios, such as debt to equity.

Lenders will look at the profitability of the company, and this will determine how much the company may be able to borrow. Moreover, if the balance sheet is strong and shows that the company can withstand a bad month or two and still be a viable company, the lender may feel more comfortable in the current lending relationship.

Suppliers will sell to their customers on credit, and the use of financial statements will assist in determining what levels of credit they can give to their customers. Also, the reports show how a customer can pay its bills and continue to operate without having a negative impact on the supplier. The supplier can see if the customer is growing and may be relying on the supplier more and more for products that will, in turn, have an impact on the supplier's daily operations.

Current employees and individuals seeking to gain employment at an organization should look at the financials of the organization to see

if it is strong enough to last into the future. The reason is simple: as employees, they will be relying heavily on the financial viability of the company that they will be working for to get a regular paycheck and continue the lifestyle that they have become accustomed to living. So, if an organization is in a poor financial position, then it will be more difficult to hire new employees or retain current employees. The financial statements can show the cash flow of the organization, how it pays its bills, if it is in a positive or negative situation with regard to the balance sheet, or if it is struggling based on its income statements. Keep in mind that the financial statements need to be accurate and timely to help the current or prospective employee make an educated decision as to whether or not to join an organization.

Accrual Accounting Method

There is an important factor in the accrual accounting method for the healthcare administrator to understand. In the accrual concept, the organization will account for revenue in the period it was incurred even though it may not have received payment yet. Moreover, for the expense part of the equation, if there are expenses incurred during a period but are not yet paid for, they too will be accounted for in the accrual method.

The goal is to have all revenues, and related expenses, accounted for in the same accounting period. This way, the utilization of assets to produce the revenue and the expenses or obligations associated with the generating of revenue are all captured in the same period. By doing so, this will bring consistency to the financial reporting, keeping in mind that it is a complicated system, and will give the individuals using the reports sound and consistent information to base their decisions on with regard to running the department or company on a daily basis.

Overall, accrual accounting focuses on the transactions that move the company and not just the cash in or cash out. Accrual accounting recognizes that revenues can be earned even before customers pay their bills. Moreover, the organization that utilizes the accrual basis will treat the company's expenses in the same way. If an expense, or invoice, comes in but is not paid in the period, the company still recognizes the expense in the same period it recognized the revenue. This level of consistency will allow for more accurate financial planning by all levels of management.

Ratio Analysis

Once all the financial statements are completed, they are ready to be used to calculate ratios, which assist in further detailing the organization's results. Another reason to look at ratios is that for an organization that is doing any financing, the lenders will look at not only the financial report results but the ratios of certain parts of the financial reports. Reviewing the ratios and comparing organizations in the same industry, or checking the organization's assets versus their liabilities based on the ratio analysis that can be performed, will assist a lender in deciding whether or not to provide financing to an organization.

Any changes in an organization's ratio analysis are of great interest to the organization and the lender. This comparative tool, when used within the organization's industry, will be of great help in comparing the performance of one organization against another to see if the results are consistent, if they are positive in comparison to similar organizations, or if they are on the decline such that practices need to be looked at immediately to address the problem.

Current Ratio

This ratio determines the ability of the organization to pay its current liabilities with the use of its current assets, which is a critical ratio for lenders today. This ratio looks at current assets, which includes cash on hand, the company's short-term investments, accounts receivable generated through sales, and inventory that the organization has at present. The category of current assets means that an organization can take these assets and turn them into cash rather quickly if needed, or during the

calendar year or fiscal year, the organization will use up these current assets in the normal course of doing business. The current liabilities are similar to the current assets in that the liabilities that are considered to be current are accounts payable and any current portion of a loan or obligation. The current ratio is calculated as follows:

$$\frac{\text{Total current assets of the organization}}{\text{Total current liabilities of the organization}}$$

The current ratio of 2.0 means that for every $1.00 of current liabilities, the organization has $2.00 of current assets to satisfy the liability.

Acid-Test Ratio

The acid-test ratio takes it a step further, as it measures current assets versus current liabilities, but using a different approach. The current assets that are measured are only those that are considered truly liquid, meaning they can be turned into cash very quickly. Inventory is used in the current ratio, but even though it may be a current asset, it is not one that can be turned into cash quickly. With that said, the acid-test ratio will take into account cash, short-term investments, and net current receivables and divide by total current liabilities. The example is as follows:

$$\frac{\text{(Cash + short-term investments + net current receivables)}}{\text{Total current liabilities}}$$

In this example, the acid-test ratio came up to be 1.75; this would mean that for every $1.00 of current liabilities, the company has $1.75 of current liquid assets to discharge this debt.

Debt Ratio

In the debt ratio, the lender looks at the total assets and the total liabilities that an organization may have on its balance sheet. The total assets of the organization are divided by the total liabilities of the organization. The result, or findings, can be used to measure similar organizations and compare operating results between them to help manage the organization (**Exhibit 2.3**).

Exhibit 2.3 **Eight Basic Ratios Used in Health Care**

Liquidity Ratios

1. Current Ratio
   Current Assets
   Current Liabilities
2. Quick Ratio
   Cash and Cash Equivalents + Net Receivables
   Current Liabilities
3. Days Cash on Hand
   Unrestricted Cash and Cash Equivalents
   Cash Operation Expenses ÷ No. of Days in Period (365)
4. Days Receivables
   Net Receivables
   Net Credit Revenues ÷ No. of Days in Period (365)

Solvency Ratios

5. Debt Service Coverage Ratio
   Change in Unrestricted Net Assets (Net Income)
   + Interest, Depreciation, Amortization
   Maximum Annual Debt Service

6. Liabilities to Fund Balance
   Total Liabilities
   Unrestricted Fund Balances

Profitability Ratios

7. Operating Margin (%)
   Operating Income (Loss)
   Total Operating Revenues
8. Return on Total Assets (%)
   Earnings Before Interest and Taxes (EBIT)
   Total Assets

Courtesy of Resource Group Ltd., Dallas Texas.

Conclusion

The importance of financial management in the healthcare organization cannot be emphasized enough. Leadership needs to understand the difference between financial and managerial accounting and the best way to use these methods to manage the operations better and more efficiently. More importantly, the leader needs to understand the data collected in the reporting process related to each type of accounting and make sure that the financial team of CPAs is well versed in all of the intricacies of accounting in a healthcare organization. The data are used to forecast revenue, manage variances, evaluate processes impacting results, manage assets and liabilities, complete the budget process, plan for the future, and maintain the financial health of the organization. Basically, the income statement, balance sheet, general ledger, and budgets are vital tools to determine the current and long-term effectiveness of the operation. If management works as hard as possible, but without direction or any measures of how they are doing, they will feel puzzled as to why the operation is not doing as well as it can or why it is failing; these issues can usually be traced back to an uninformed manager or leader. It is hard to imagine, but if they are managing a facility and they do not know the flow of financial information and the reports that reflect their operations, it should be no surprise that they are failing. Even more of a surprise is that all of the information is right in front of them in their financial statements, budgets, and ratios. This information will be very helpful to assess where they are at currently in their operations and what they need to do to achieve their financial and operational goals for the future.

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