Overview of Financial Statements

2

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Learning Outcomes

By the end of this chapter, you will be able to:

- Describe the role of financial accounting in healthcare organizations
- Discuss financial accounting principles
- Explain the information contained in a balance sheet
- Discuss the components of an income statement
- Identify the information contained in a statement of cash flows
- Explain the purpose of activity measures and community benefit statements

Introduction

Chamberlin Skilled Nursing, Inc. is a 54-bed nursing home providing skilled nursing care, mostly to persons with Medicare coverage. Most residents receive care for two to three weeks after a hospitalization or other major medical event. With Medicare as its major payer, Chamberlin is subject to the government's annual process of payment determination. More than half of their expenses are associated with payroll and benefits of its nursing staff. Substantial revenues and expenses are also attributable to physical therapy, occupational therapy, and medications provided to recovering residents. To maintain even a slim amount of profit, the financial accountant at Chamberlin tracks the dollars coming in and the dollars going out very closely.

The process of tracking the dollars at Chamberlin Skilled Nursing, and all organizations, is the responsibility of financial accounting. Their formal reports are financial statements, which provide information on the current status of the organization and its recent financial performance. With a good understanding of the process that leads to the preparation of financial statements, and a good understanding of the content of the statements, managers can use the information to lead the organization. Financial statements also permit persons outside of the organization to understand its financial position and performance and to make their own assessments of the organization.

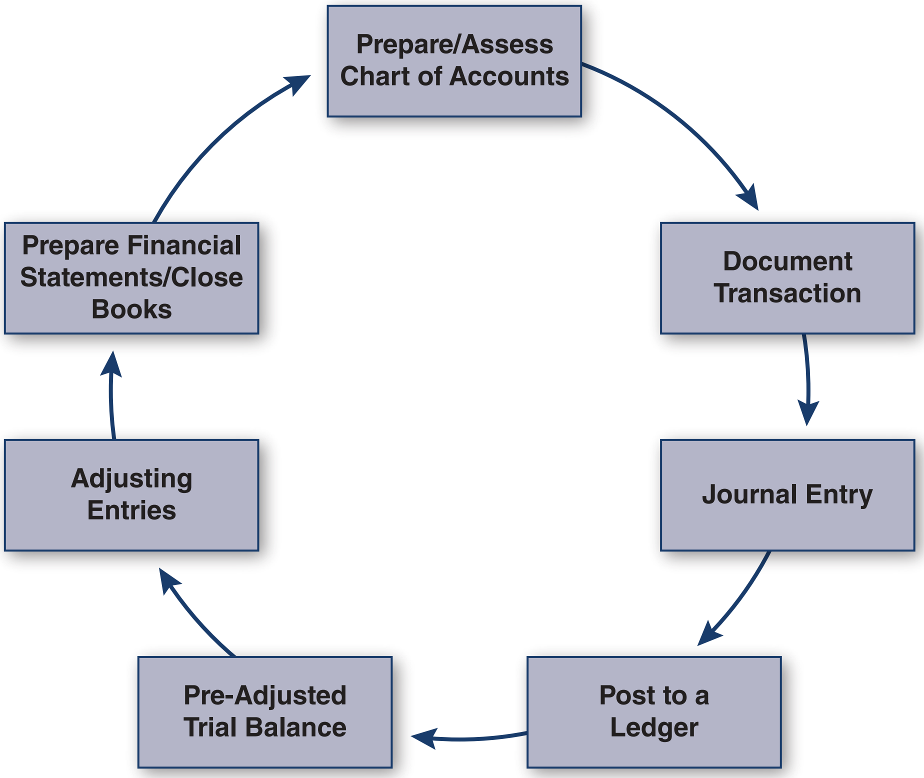
2.1 The Role of Financial Accounting

Financial accounting is responsible for recording and compiling business and financial transactions, assuring the accuracy of transactions, and preparing reports of the results. To comprehensively record all transactions, financial accounting must be involved in almost every aspect of managing an organization. Its role is highly visible when it is actively involved in the recording of large transactions, such as the purchase of a new building or medical equipment. Financial accounting is less visible, but no less important, as it passively captures each service that is provided to patients through the billing system.

Cycle of Activity

Financial accounting follows a cycle of activity that continues throughout the year. A view of this cycle is presented in Figure 2.1. It all starts with a system to record transactions. All organizations maintain a **chart of accounts**, or a listing of accounts that they envision using to record transactions. Organizations maintain a chart of accounts as a means of standardizing the classification of entries and permitting computerization of accounting.

Figure 2.1: The accounting cycle



The Office of Statewide Health Planning and Development, State of California (2012) provides a sample chart of accounts for use by California hospitals, a small portion of which is presented in Exhibit 2.1. In the complete version of this chart of accounts, there are more than 200 accounts of **assets**, **liabilities**, and **fund balances** and nearly 600 accounts for **revenues** and **expenses**. Beyond the general categories there are details for specific purposes. For example, under category 1001 “General Checking Accounts,” there might be an account 1001.01 for a checking account at Bank of America and an account 1001.02 for a checking account at Wells Fargo. Thus, a full hospital chart of accounts can include thousands of specific accounts.

Exhibit 2.1 A portion of a hospital chart of accounts

Assets

Current Assets

1000–1009	CASH
1001	General Checking Accounts
1002	Payroll Checking Accounts
1003	Other Checking Accounts
1004	Minor Expense Cash Funds
1005	Savings Accounts
1006	Certificates of Deposit
1007	Treasury Bills and Treasury Notes
1009	Other Cash Accounts

Source: Office of Statewide Health Planning and Development, State of California (2012)

The active aspect of financial accounting starts with initial data capture. Based upon formal documents or substantial evidence that a financial transaction has occurred, it is the role of financial accounting to analyze and record the transaction in a consistent manner. For routine transactions, documentation may be standardized and already prepared by the accounting information system. Records of the number of hours worked by nurses and other staff are an example of routine transactions. For nonroutine transactions, such as the purchase of a new piece of equipment, the receipt and other documentation of the purchase and installation may be required. Each transaction is analyzed to assure that its inclusion in the financial accounting system is appropriate and to determine which accounts are involved.

The initial recording is called a **journal entry**—as accountants often use the term *journal* to reflect the transactions involving an account. Again, for many routine transactions, documentation may be presented and directly entered through the information systems of the organization. Recording of the hours worked by a nurse may be routinely performed by a clerk who enters the hours into the information system. In larger organizations, recording of hours worked may require approval by a supervisor. The direct payment of employees' paychecks into their bank accounts represents a routine transaction that may be performed automatically by the accounting information system. Nonroutine transactions, such as the purchase of a new piece of equipment, may be manually entered into the accounting system, with references to the equipment and the method of payment.

An important aspect of accounting practice is the double-entry nature of recording transactions. Every transaction involves two entries into the accounting system, affecting one or more journals or accounts. For example, a hospital might redeem certificates of deposit at a bank if it needs more funds in payroll checking accounts. Thus, the transaction involves decreasing the account of certificates of deposit and increasing the payroll checking account by the same amount. The general process of increasing and decreasing amounts in accounts is termed *crediting* and *debiting*, terminology that we will not belabor in this textbook, but which are commonly used in accounting practice.

After transactions have been initially recorded, they are also recorded in a summary listing of accounts. This second step of recording is termed **posting to a ledger**. A ledger is a summary of the transactions for a particular account. In the case of account 1001.01 for a checking account at Bank of America, the ledger would provide a listing of all deposits and checks written on this account. All organizations maintain a general ledger that includes all accounts. Further, many organizations maintain subsidiary ledgers that maintain the accounts of individuals and companies with which they conduct business. Hospitals regularly maintain a subsidiary ledger for every patient and insurance company. The general ledger for amounts owed by patients is termed the *control account* for all of the individual patients' accounts. With the control account, the hospital knows at every point in time how much it is owed from all patients, without having to look at each individual patient.

Periodically, a **preadjusted trial balance** of all accounts is prepared to assure that all transactions have been properly reported. Since every transaction involves two entries in the accounting system, the preadjusted trial balance serves as a check that the sum of all increases and decreases are balanced. It is still possible that errors were made in the entries of particular accounts, but it provides some assurance that there were not simple math errors or failures to properly record transactions. For example, if $10,000 were transferred from a savings account to a checking account, the dollar amount of the entries should be the same for both accounts. If there was a $10 fee by the bank for this transfer, and it was not recorded, then the $10,000 decrease in the savings account would not balance the $9,990 addition to the checking account. The preadjusted trial balance permits periodic checking of transactions. With good information technology, the need for preadjusted trial balances has been reduced. Still, because entries can be done manually, there is always the chance of an error.

Analyze This

If financial accounting made a journal entry of an increase in a checking account without reporting on another account, what information would be missing from the accounting system?

At the end of accounting periods (monthly, quarterly, or annually), a series of adjusting entries are recorded. **Adjusting entries** are required to acknowledge that the values in a number of meaningful accounts have changed, even when an explicit transaction has not occurred at the same time. For example, at the beginning of a year, an organization may make a payment for the purchase of property insurance. This purchase would be recorded as a decrease in a general checking account and an increase in a prepaid expense: insurance account. As each month passes, the value of the protection made available through the insurance coverage is recognized as an expense, and this recognition comes in the form of an adjusting entry. Financial accounting is responsible for noting when transactions, such as the purchase of insurance, will involve future adjusting entries and for reporting those adjusting entries.

Financial statements can be prepared after trial balances have been verified as being correct and all adjusting entries have been made. The key financial statements include the balance sheet, the income statement, and the statement of cash flows, which will be detailed later in this chapter. Each of these statements summarizes selected accounts from the accounting system. The balance sheet summarizes the amounts in asset, liability, and net asset accounts. The income statement summarizes the revenue and expense accounts, as well as gains and losses from changes in asset and liability accounts. The statement of cash flows provides details on the cash account from the balance sheet and highlights transactions that yield changes in cash balances associated with operating, investing, and financing activities.

Finally, after the financial statements have been prepared, organizations **close the books**, meaning that they stop making changes to accounts for the time period covered by the financial statements and make entries that mark the end of the time period. The closing process also involves preparation of a closing balance, which, like the trial balance, provides some assurance of no math errors. This closing balance then becomes the opening balance for the next time period. Before the first transactions are made in the next period, there may be a review of the chart of accounts and changes made if new accounts are required or if unused accounts can be deleted.

In following the cycle of activities prescribed for financial accounting, it is clear that financial accounting is involved in all of an organization's transactions and keeps accounts on all persons and corporations with which the organization conducts business. At a minimum, the role of financial accounting includes recording and compiling transactions, assuring the accuracy of transactions, and preparing reports of the results. Due to the intimate role of accounting in the recording and reporting processes, accounting may also be involved with the transaction itself. In small organizations, the accounting clerk may work closely with supervisors for recording payroll and with individuals responsible for ordering supplies. In larger organizations, the jobs become more specialized. By being involved in transactions directly, accounting can assure that transactions yield accurate and consistent recordings and assure that reporting of results is correct.

The Users and Regulators of Financial Accounting Information

With financial accounting information including summaries of all transactions that occur for an organization, there are a number of persons who use this information and a number of parties that regulate the information. The list of users of financial accounting information begins with the management of the organization itself. Financial information provides one set of measures on organizational performance. Managers and others care about quality of care, access to services and community benefits, and also financial performance. Managers will look to the financial reports to see the levels of assets and liabilities held by the organization as well as the revenue, expenses, and net income earned in recent accounting periods. These reports help to guide decision making on asset management, debt management, and the resources devoted to services that yield the earning of net income. Along the same lines as managers, boards of directors and others involved with the governance of organizations rely upon financial statements as their source of information on financial aspects of performance.

Many individuals and businesses with an interest in an organization use the organization's financial statements. Individuals or companies to whom an organization owes money will carefully examine that organization's financial statements. In addition to the financial statements as a whole, debt holders may require presentation of selected values from financial statements in special reports to meet their information needs. For example, many companies representing debt holders require presentation of selected information related to a hospital's ability to make required debt payments. Based upon the information from financial statements, they may require special reports on how much debt is owed, how much the organization is earning each year, and how much money is available for making debt payments.

Various government agencies including Medicare, the federal program that provides insurance for the aged and disabled, and Medicaid, the state-federal program that provides insurance for the poor require the submission of annual financial statements. Medicare and Medicaid rely upon financial statements for analysis of the adequacy of insurance payments.

Another government agency, the Internal Revenue Service (IRS), requires submission of tax returns, which are based on financial statements. Even organizations that are exempt from income tax, including most not-for-profit healthcare organizations, must file tax returns:

Form 990, Return of Organization Exempt From Income Tax (http://www.irs.gov/uac/Form-990,-Return-of-Organization-Exempt-From-Income-Tax-). Schedule H of the Form 990 (http://www.irs.gov/pub/irs-pdf/f990sh.pdf) requires detailed information on the financial assistance and community benefits provided by not-for-profit organizations. The IRS uses this information to assess whether not-for-profit organizations deserve their tax-exempt status. Because these tax returns are publicly available, boards of directors and other interested parties may also use this information to assess whether the organization is meeting its mission.

Regulation of Financial Accounting

To assure users of financial statements that the information is recorded and presented appropriately, there are a variety of bodies that regulate or provide input into the regulation or setting of standards for financial accounting. Legally, the IRS and Securities and Exchange Commission (SEC) have the authority to define accounting practices that meet their requirements.

As a practical matter, the starting point for standard setting is the Financial Accounting Standards Board (FASB) for investor-owned and community not-for-profit organizations, and the Governmental Accounting Standards Board (GASB) for governmental organizations. Using a process that involves widespread discussion, deliberation, and dissemination, FASB provides the standards that are accepted by the IRS and SEC for reporting financial information. The end product of FASB's work is a set of generally accepted accounting principles that guide recording and reporting (Larking & DiTommaso, 2012).

Two related parties provide additional details that assist healthcare organizations' financial accounting. The American Institute of Certified Public Accountants' (AICPA) Committee on Healthcare and the Healthcare Financial Management Association's (HFMA) Principles and Practices Board exist to provide guidance to FASB on standards affecting healthcare organizations and to provide guidance to healthcare organizations on practices that are too detailed for inclusion in FASB standards.

For Review:

1. Why do organizations maintain a chart of accounts?
   A chart of accounts is required to provide consistent recording of financial transactions. It is desired because it permits identification of all details of an organization upon which they may report results.

2. What are the seven steps in the account cycle?
   The accounting cycle starts with the preparation or assessment of the chart of accounts. Transactions are documented, journal entries are made, and results are posted to a ledger. To assure that the double-entry system has been followed, a preadjusted trial balance is prepared. At the end of an accounting period, adjusting entries are recorded, financial statements are prepared, and the books are closed for the period.

2.2 Financial Accounting Principles

There are several assumptions about organizations and principles of accounting practice that guide the recording and reporting of financial information, as indicated in GAAP. Each of the assumptions and principles is necessary to prepare financial statements that can be understood by persons who might not be familiar with an organization. Additional explanations are required only when specific assumptions are not met or principles are not applied.

Assumptions

A set of assumptions that form the basis for the application of GAAP starts with the definition of the **entity**. Financial accounting is assumed to be concerned with information on a specific entity—be it a clinic, hospital, or health system. Understanding the specific entity to which the financial information applies is important and yet sometimes difficult to know without a clear indication. It is important to be clear on the ownership of an asset among entities, as well as the recipient of revenues and obligations of expenses. Since it is not uncommon for one accounting entity (e.g., a skilled nursing facility) to exist within a larger entity (e.g., a health system that includes multiple hospitals or other organizations), the definition of the entity is often included as the first of many footnotes of financial statements.

Another assumption is that of treating the organization as a **going concern**. A going concern is an organization that is expected to be in existence for the foreseeable future. The principles of accounting, particularly for the assets of an organization, are very different if one considers it to be a going concern as opposed to an organization that might close in the coming year. If a clinic is treated as a going concern, you can measure the value of its equipment by its purchase price. If a clinic may go out of business, you may need to measure the value of its equipment by what it might sell for at an auction, which is a much more difficult task.

All financial transactions are assumed to be recorded in monetary units (i.e., dollars), with clear notes if transactions are converted among different currencies. This assumption implies that there can be clear documentation of the dollar value of all purchases and sales. In most instances, this assumption easily holds. When a patient purchases a prescription drug from the hospital pharmacy, the amount paid will be clearly indicated, and documentation of the transaction will be created. On the other hand, when a donor provides a hospital with a piece of land for construction of a new clinic, formal appraisals must be obtained to know the value of the transaction.

The final assumption is that there is a formal and explicit definition of the **accounting period** being represented by a financial statement. Applying a financial statement to the first month of one year, as opposed to the full year, could result in a different interpretation of the financial results, such as the revenues or expenses.

Principles

In terms of principles, the starting point is **objectivity**. Recording of transactions are expected to be based upon evidence that can be verified and would be accepted by persons outside of the organization. Even though financial accountants may be employed by a hospital, their work should be performed such that any similarly educated person would record transactions in the same way and produce reports with the same results.

For purposes of objectivity and the related principle of **reliability**, which requires that transactions be accurate and complete, most assets held by organizations are reported at their purchase price, which is also called its historical cost. Historical costs do not change and can be verified. Along with the principle of going concern, assets can be presented at historical cost and not using assessment of current market value or cost of replacement. Along these same lines, revenues are not counted until they have been earned. Revenues are considered to be earned after a service has been provided and the amount that is likely to be paid for that service has been analyzed. A principle that is embedded within reliability is that of **conservatism**, which cautions against overstating assets or net income.

Transactions and reports are also expected to contain information that is **relevant** to the organization. Relevance refers to the information being associated with the entity and the information potentially making a difference to users. A challenge with the determination of relevance is that there may be many individuals, banks, and other organizations that use the financial statements of a healthcare organization. Different users may have differing needs for detail provided in financial statements. The principle of relevance requires that transactions are recorded on a timely basis and reflect true values. The principles of reliability and relevance can sometimes be at odds with one another. In fact, there is a movement toward reporting monetary assets (e.g., stock and bonds) at market value, which is more relevant, rather than at historical cost, which is more reliable.

A principle of **comparability**, or matching, requires that expenses should be recorded in the same period as the revenues that caused the expenses to be generated. As a result of this principle, organizations following GAAP use **accrual accounting** rather than **cash accounting**. For healthcare organizations, accrual accounting means that expenses and revenues are recorded when services are provided to patients. The actual cash expenditure associated with an expense (e.g., bandages) will likely occur well before the service is provided. The actual cash receipt of payment will likely occur well after the service is provided, particularly if the service is covered by insurance. By matching expenses and revenues, we obtain an accurate picture of the important events that happened in a time period (the provision of services to a patient). The potential mismatch between when expenditures occur and expenses are recorded and when revenues are earned and payments are received is the reason for the preparation of a statement of cash flows. For personal accounting practices and that of many small companies, cash accounting is employed for its simplicity.

A final principle is that of **full disclosure**. Organizations are expected to record all transactions, yet only report those account balances that are of sufficient magnitude and importance to decision making to justify presentation on financial statements. Within this principle is a test of **materiality**, which asks whether an error in recording or reporting results is a significant misinterpretation of the financial status of an organization. For purposes of full disclosure, the amount of cash held is sufficiently important to be reported on financial statements, regardless of the amount. In fact, having a very small amount of cash might make this reporting especially important. Similarly, the total value of patient accounts receivable—the amounts owed to the organization by patients and insurance companies—is important to report on financial statements, though the source of the amounts owed by specific payers, like Medicare and Medicaid, may only be reported in footnotes of financial statements, if at all. A healthcare organization may have contracts with dozens of insurance companies and the amounts owed by each may not be sufficiently important to disclose. Weighing the materiality of reporting items on the financial statements or in its footnotes is an important task of financial accounting and is tested by external auditors.

An important constraint on adherence to accounting principles is that of **cost**. The value of recording and reporting financial information must be weighed against the cost associated with the recording and reporting process. Organizations are expected to use the same recording and reporting methods in each accounting period (**consistency**) unless the costs of doing so or the circumstances of an organization have changed such that different methods are more appropriate. Full disclosure requires the reporting of any changes in accounting methods. The cost principle or constraint on principles is difficult to employ, as the value of unreliability, mismatching, and failure to fully disclose information may not be well understood as accounting systems are being developed. The excuse of "I didn't think that it was worth the cost of recording *all* bank loans" may not be accepted upon the default on a loan.

Each of the principles is necessary as a foundation for how transactions are recorded and reported. For organizations that follow all accounting principles in standard ways, the financial statements may be easily read and interpreted by managers and other interested persons. For organizations that do not follow all accounting principles, additional explanations may be required.

Internal Controls

Following GAAP requires discipline on the financial accounting for an organization. The discipline employed in financial accounting is characterized by the **internal controls** put in place to provide reasonable assurance that assets are safe and that the accounting records are reliable. The ultimate responsibility for internal control rests with the key executives and boards of directors. Internal controls are implemented by senior financial personnel. Auditors regularly verify the use of internal controls and their effectiveness. Good internal controls start with an environment where the organization recognizes the importance of accurate and timely financial information and there is respect for following GAAP. If there is insufficient recognition of importance, sufficient resources may not be provided for conducting financial accounting according to GAAP. If there is insufficient respect for the process, individuals may not be motivated or held accountable to high standards of objectivity and reliability.

Establishing a process of good internal controls requires an assessment of risks to following GAAP and the associated recording of transactions and reporting of results. Risk assessment is the process of envisioning risks to good accounting practices and developing probabilities and monetary consequences when these practices are not followed. Clearly identified and measured risk can be managed through the application of information and communication systems and specific risk control strategies.

Accurate reporting and verification of information related to potential financial transactions requires systems, processes, and procedures to manage the flow of the immense amount of data generated in healthcare organizations. Hendrickson Memorial Hospital, with financial statements included in Appendix A, had 116,459 inpatient admissions, 120,240 outpatient visits, and 36,360 emergency department visits in 2012. These visits generated an immense amount of data that is potentially related to financial transactions. In fact, merely accounting for the time-keeping, payroll, employee benefits, and associated taxes for 3,000 employees generates data that requires good systems, processes, and procedures to manage.

Effective control relies upon not just the written policies and procedures but also well-trained, competent personnel to follow and interpret the policies and procedures. Ideally, duties among personnel would be separated so that different people record and verify financial information and these employees are rotated among the different assignments. It is not ideal to have the employee who operates the cash register in a clinic also count the money at the end of the day and also reconcile patients' billing accounts with cash paid. This would provide too many opportunities for cash to be misreported or, worse, missing. In practice, there are trade-offs between the advantages of specialized knowledge associated with having long-term relationships and responsibilities for operations and the verifiable integrity of a control system. Errors in judgment or lack of integrity can be hidden for long periods of time without clearly defined responsibilities and rotation of duties.

Finally, good internal controls require monitoring to assure that the climate is maintained and that policies, procedures, and action are followed. Annual audits now routinely assess internal controls and may offer recommendations for improvement. The importance of good internal controls has gained visibility and attracted more monitoring and reporting after the financial scandals that led to the passage of the Sarbanes–Oxley Act of 2002. This act requires greater disclosure of accounting practices than were previously employed by some companies (Securities and Exchange Commission, 2013).

Analyze This

Melissa Hanks Bordelon, former chief financial officer of Acadian Medical Center in Eunice, Louisiana, was sentenced to 18 months in prison and ordered to pay restitution for embezzling $192,000. Ms. Bordelon had the hospital issue checks for its student loan repayment program in excess of the amount of the loans. She used the excess amounts for personal expenses.

Where did internal controls fail at Acadian Medical Center?

Source: Becker's Hospital Review (2010).

For Review:

1. What are the three key assumptions about healthcare organizations used to apply generally accepted accounting principles?
   The three assumptions are that the organization is a clearly defined entity, that it is a going concern, and that transactions apply to a specified time period.

2. What are seven key principles applied in financial accounting?
   Key principles include objectivity, reliability, conservatism, relevance, comparability, full disclosure, and consistency.

3. Why are internal controls important? Who is responsible for assuring good internal controls over financial information?
   Internal controls permit an organization to follow generally accepted accounting principles and produce financial statements that fairly depict the organization. The senior executives (CEO and CFO) and the board of directors are ultimately responsible for the financial statements and assuring good internal controls around their preparation.

2.3 Balance Sheet Basics

A **balance sheet** is a presentation of the assets, liabilities, and the net assets of an organization at a point in time. In essence, a balance sheet is a snapshot of an organization's financial standing. It captures what the organization possesses to engage in its activity (assets), how much it owes to other organizations and individuals (liabilities), and therefore how much of the organization it owns outright (net assets). The name *balance sheet* comes from the requirement that the two sides of the **basic accounting equation** are equal:

$$\text{Assets} = \text{Liabilities} + \text{Net assets}$$

The observation that a balance sheet actually balances is an outcome of the double entry nature of financial accounting. The addition of an asset (e.g., purchase of equipment) generally comes from either the substitution of another asset (e.g., cash) or the addition of a liability (e.g., a loan). Careful financial accounting assures that the balance sheet always balances. The balance sheet for Chamberlin Skilled Nursing is presented in Exhibit 2.2. A more complicated balance sheet, Hendrickson Memorial Hospital, is presented as the first financial statement in Appendix A.

Exhibit 2.2 Balance sheet, Chamberlin Skilled Nursing

	2012	2011
Assets		
Cash and cash equivalents	$731,690	$615,397
Resident accounts receivable (net of allowance for Doubtful accounts of $18,000 in 2012 and $20,000 in 2011)	1,145,073	1,183,457
Inventories	93,909	116,688
Prepaid items	21,470	26,541
Total current assets	$1,992,142	$1,942,083
Assets limited as to use	$462,734	$493,798
Property, plant, and equipment	$960,431	932,357
(Accumulated depreciation)	(348,960)	(219,347)
Net property, plant, and equipment	611,471	713,010
Other long-term assets	79,025	64,323
Total long-term assets	690,496	777,333
Total assets	$3,145,372	$3,213,214
Liabilities		
Accounts payable	$187,818	$233,376
Accrued payroll-related liabilities	$331,227	$352,081
Other accrued liabilities	$29,706	$2,730
Total current liabilities	$548,751	$588,187

(continued)

Exhibit 2.2 Balance sheet, Chamberlin Skilled Nursing *(continued)*

Long-term liabilities		
Mortgages	$1,426,660	$1,457,356
Notes payable	$534,699	$599,671
Total long-term liabilities	$1,961,359	$2,057,027
Total liabilities	$2,510,110	$2,645,214
Net assets	$635,262	$568,000
Total liabilities and net assets	$3,145,372	$3,213,214

Source: Author's calculations.

Assets

Assets are physical or financial items that can be owned and facilitate the operations of an organization. Many assets have physical forms, like buildings, that are clearly identifiable and can be verified and have their value assessed. Other assets may not be in direct physical form, such as cash in a checking account, but they are still identifiable and can be verified and assessed for value. There are still other items that organizations refer to as assets because they facilitate operations, but they are not assets in a financial accounting sense because they cannot be owned. For example, having a reputation for quality and patient satisfaction may be beneficial to the hospital, but it does not appear on the balance sheet.

Assets are presented on the balance sheet in three general categories: current assets, assets whose use is limited, and long-term assets.

Current Assets

Current assets are either in the form of cash at a point in time or are expected to be translated into cash within a short period of time—typically one year. Current assets are generally listed on the balance sheet in terms of liquidity, or how quickly they can be translated into cash.

Cash and cash equivalents are the most liquid current assets. Cash includes not just the physical money that is held in cash registers but also funds held in checking and savings accounts. Cash equivalents are generally defined as funds held in debt instruments (e.g., government treasury notes) with original maturities of three months or less.

Patient accounts receivable are the amounts owed to the organization by patients or their insurance companies. Balance sheets of healthcare organizations list the total amount of patient accounts receivable as well as the estimated allowance for **doubtful accounts**. Doubtful accounts are those accounts one does not expect to be paid; they do not, on average, necessarily concern specific patients or insurance companies. In industries other than healthcare, doubtful accounts are called *bad debts*. Some patients will lose their ability to pay due to illness or injury, loss of a job with insurance, or other circumstances. Some insurance companies will not pay bills submitted due to lack of coverage for the patient who claimed coverage, lack of coverage for the specific service provided, or other circumstances. Financial accounting in healthcare organizations often devotes substantial resources toward assuring that bills submitted to patients or insurance companies are accurate and complete. Still, there are substantial sums that will not be collected, and therefore an estimate is provided on the balance sheet as an act of full disclosure. In addition to amounts owed for patient services, other individuals or organizations may owe amounts that are summarized as other receivables.

Analyze This

Chamberlin Skilled Nursing estimated an allowance for doubtful accounts of $18,000 in 2012 and $20,000 in 2011. What might explain the differences in the allowances between these two years?

Inventories are the dollar value of drugs, medical supplies, and other products that are purchased for use in the provision of services to patients. Even though not all drugs and medical supplies may be used within the same year that they are purchased, they are potentially available for use and are therefore considered to be current assets.

The final category of current assets is **prepaid expenses**. As noted previously, an example of prepaid expenses is insurance. When insurance premiums are paid, an organization holds the asset of protection against a loss. Similarly, when an organization pays rent on property or equipment, it holds the asset of the property or equipment until the rental period is over. Because most insurance covers a single year, as do many rental agreements, prepaid amounts are generally current assets.

Balance sheets will often also include a category of other current assets to reflect assets that don't fit into one of the specific categories and are not of sufficient value to warrant creation of a new category. Examples of other current assets include equipment that is not currently being used for patient care and is being prepared for sale and cash advances paid to employees for travel to continuing education programs.

Assets Limited as to Use

Assets limited as to use defines assets that have restrictions on their use that were imposed by the organization itself or, more frequently, by an outside party. Assets limited as to use are often held in the form of financial assets (stock and bonds) or holdings in other companies. They include assets that are temporarily or permanently restricted, with restrictions that are internally or externally imposed. Temporarily restricted assets may be used when a specific need or purpose arises. When assets limited as to use are released from their restriction, they can be used by the organization and may be listed as current assets until they are used. For example, a healthcare organization may have assets set aside for new buildings. Once the new buildings are under construction, a portion of the assets may be transferred to current assets as payments are required.

Permanently restricted assets are those that cannot be used, although some portion of the investment earnings, interest and dividends, can be used. For example, if a clinic is provided with an endowment of $100,000 in order to train nurses, this principal amount cannot be used. Investment earnings on the $100,000, perhaps $10,000 in a year, may be used to pay for training programs or left in the endowment to provide for larger investment earnings in the future.

Larger healthcare organizations often hold some funds in cash and cash equivalents for transactions purposes, such as paying employees and suppliers, and they may also hold substantial amounts of financial investments in accounts designated as assets limited as to use for precautionary and speculative purposes (Rivenson, Reiter, Wheeler, & Smith, 2011). Precautionary amounts are those held to protect the organization's ability to pay its bills in the event of changing payment systems or other risks. They are held to protect the organization and to protect individuals or firms that loan money to the organization. Organizations that hold substantial amounts for precautionary purposes may be rewarded with lower interest rates from lenders who recognize lower risks for loan repayment.

Speculative amounts held as assets limited as to use are investments that are designed to increase in value for the future benefit of the organization. Investments in financial assets and direct investments in other companies may provide earnings that can subsidize unprofitable services that are important for the fulfillment of a healthcare organization's mission as well as provide resources for future plant replacement and expansion.

The reasons for the limited use of assets may come from decisions that are made internally to the organization or externally by donors or investors. Internally, the board of directors can restrict funds for specific purposes, be it for plant replacement and expansion or for undesignated precautionary or speculative purposes. Such restrictions can place financial discipline on the management of an organization, but it can be changed by the board at their discretion. Externally, donors often place restrictions on the use of their donations. The use of endowments to create permanent programs or services is quite common.

From the Front Lines

We just increased our board-designated assets limited as to use for precautionary purposes in order to plan ahead. We are changing our payment model with commercial insurance companies later this year, and we know that, as a result, our utilization of inpatient services will decline. We also know that we must continually invest in information technology to support changes to the care delivery model. Therefore, we are being cautious with our finances and are restricting how we use our money.

Source: Health system vice president.

Long-Term Assets

Long-term assets are not expected to be converted into cash or cash equivalents within a year. Generally, long-term assets, sometimes called fixed assets, represent the physical assets that permit the provision of healthcare services. Separately or combined as one line, the amount of property, plant (buildings), and equipment purchased by an organization is usually its largest long-term asset. Other fixed assets may include patents, copyright, and other assets that are not used in the delivery of health services. All assets are initially recorded at their purchase price.

A unique feature of long-term assets is that they are used over time. Even though the details of how accounting recognizes that they are used over time are provided later in this chapter, the general concept is that, to follow the matching principle, the cost of buildings and equipment should be recognized over the course of their useful life. Thus, the balance sheet includes the initial value of property, plant, and equipment, the amount of depreciation expense that has been accumulated since the assets were purchased, and the difference being the net property, plant, and equipment.

Liabilities

Liabilities are the amounts the organization owes to other businesses or individuals. They are presented on the balance sheet in two general categories: current liabilities and long-term liabilities.

Current Liabilities

Current liabilities are obligations that are expected to be paid within the year. For debts that extend beyond one year, like mortgages, leases, and pensions, the payments that must be paid within a year are listed as current liabilities. They are presented separately to highlight an organization's need for resources to pay liabilities due within a year and to permit a comparison with available resources, namely current assets.

Many obligations are explicitly expected to be paid within a year. For many purchases of medical products and supplies, the payment is not made at the time of the receipt of the goods. Instead, an accounts payable is created with the bill being due within 30 days, sometimes with a discount if it is paid sooner.

Salaries, wages, and payroll-related expenses (medical insurance, payroll taxes, etc.) are accrued each day as employees work for the organization, but are paid at the end of the week or month and certainly are paid within a year. When balance sheets are prepared on a day that doesn't match payday, there are obligations for accrued salary, wages, and payroll-related expenses.

At the time a balance sheet is prepared, there may also be accrued interest payable on short-term obligations and other current liabilities. There is also often recognition that the amounts paid to the organization by insurance companies might not be exactly what should have been paid, though a final determination of the correct amount may take months to resolve. Depending on the nature of the estimates, there may be short-term liabilities if they have potentially been overpaid (or short-term assets if they have been underpaid) of estimated third-party payer settlements.

Analyze This

Chamberlin Skilled Nursing's total current liabilities were $548,751 in 2012. Should they be concerned about their ability to pay this debt in the current year? What information should you have to assess their ability to pay this debt?

Long-Term Liabilities

For larger organizations, the amount of long-term mortgages, bonds, or other forms of long-term debt will be the largest **long-term liability**. Other long-term liabilities include notes and loans payable to banks and other lenders, long-term lease obligations (also called capital leases), estimated liabilities for any self-insurance claims, and accrued pension and post-retirement healthcare costs. In each type of long-term liability, there may also be a current liability portion that is due within the year.

Net Assets

Net assets represent the value of the organization's assets after subtracting the value of the liabilities. In some presentations of balance sheets of not-for-profit organizations, net assets may be presented as the fund balance or a set of funds. In smaller organizations and in

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organizations that do not have donor restrictions on assets limited as to use, there will only be one fund and no special accounting techniques are required. For investor-owned companies, also called for-profit companies, net assets are called **equity**, owners' equity or shareholders' equity. In all cases, net assets can be considered as what the organization owns after all the bills have been paid. Within not-for-profit organizations, the owners are the community as a whole, which can be difficult to define. For investor-owned organizations, the owners are those who hold the stock of the company.

Fund Accounting

Not-for-profit organizations are unique in that they may present net assets as a set of funds reflecting the restrictions placed upon certain assets, a practice called **fund accounting**. As noted with assets limited as to use, there may be restrictions upon the use of resources available to the organization, and these restrictions are reflected on the net assets side of the balance sheet. Three types of funds may be used to represent the types of restrictions placed upon the use of resources: unrestricted, temporarily restricted, and permanently restricted.

There is only one **unrestricted fund**, often called the **general fund**, and it represents the net assets associated with the operations of the organization. In fact, if there are no changes in the structure of an organization other than carrying on operations, the net income (net loss) will be reflected in the increase (decrease) in the balance of the general fund. If someone gives an unrestricted donation of cash to a not-for-profit healthcare organization, the donation will be recorded as **nonoperating revenue** and subsequently, through an increase in net income, be reflected as an unrestricted net asset.

Restrictions on net assets can arise from internal or external sources. The board of directors can internally restrict funds that would otherwise be in the general fund; these funds are termed *board-restricted* or *board designated funds*. Donors, grant agencies, lenders, and others can impose external restrictions on funds. In some cases, there may be legal obligations to designate funds associated with external restrictions. In addition to the designation of the funds as being temporarily or permanently restricted, there may be other designations associated with the expected use of the funds. Common uses of restricted funds include building projects, provision of charity care, and endowments for specific purposes.

One common type of temporarily restricted fund is a plant replacement and expansion fund. Donations or monies set aside for building projects may be designated as being temporarily restricted in the plant fund. When the building project has been completed, the restriction is removed, and the amount in the plant fund is transferred to the general fund. (For these same building projects the investments being made in assets are designated as construction-in-progress, which is a type of asset limited as to use. When the building is completed, it is transferred to property, plant, and equipment, which is a long-term asset.)

Another common type of temporarily restricted fund is associated with charity care or other special services being supported by a donor or grant funding agency. When assets are used to pay for the services associated with the gift or grant, the amounts in the temporarily restricted funds are reduced.

A final type of fund is a permanent fund, often also termed an *endowment fund*. The essence of a permanent fund is that the assets associated with the fund—typically held as financial investments—are not to be used for the purpose of the fund. Only the investment earnings on the financial investments may be used by the organization. Depending on the purpose of the endowment, it may be that all earnings are used every year, or that only some of the earnings are used and the endowment fund may grow over time.

As you have seen, the balance sheet provides a complete listing of the assets, obligations, and net assets of an organization at a specific point in time. As such, it provides an indication of many events that have occurred in an organization's history. The balance sheet lists all of the items the organization has purchased that are still held, and all the amounts that it has borrowed that it still owes. Balance sheets are conventionally reported in a comparative manner, presenting value for both this year and last year. The transactions that occur during the year that lead from one balance sheet to the next are summarized in the income statement and the statement of cash flows.

For Review:

1. What is the basic accounting equation?
   Assets = Liabilities + Net assets

2. What is the difference between current and long-term assets?
   Current assets are either cash or can be expected to be converted into cash within a year. Long-term assets will remain in their current form (e.g., buildings and equipment) for more than one year.

3. What is the difference between current and long-term liabilities?
   Current liabilities are obligations that are expected to be paid within a year. Long-term liabilities will remain obligations that will not be paid for at least one year.

4. What is the difference between assets and net assets?
   Assets are the physical and financial items that an organization has under its control. Net assets represent that portion of the value of the assets that are owned by the organization. Net assets are the value of the assets, less the total amounts owed to other parties (which are the liabilities).

2.4 Income Statement Basics

An **income statement** is a presentation of the revenues, expenses, and net income of an organization over an accounting period. The income statement may also be called the *statement of operations* or the *statement of revenues and expenses*, which are common labels in not-for-profit healthcare organizations. The income statement captures how much the organization expects to be paid for the provision of services (its operating revenues), how much it expects to spend to provide those services (its operating expenses), and its earnings from investments and other nonoperating activities. Organizations may also yield gains or losses from the sales of assets not related to patient services, such as the sale of an old X-ray machine. The general equation for the income statement is

$$\text{Net income} = \text{Revenues} - \text{Expenses} + \text{Gains} - \text{Losses}$$

The income statement for Chamberlin Skilled Nursing is presented in Exhibit 2.3. A more complicated income statement, Hendrickson Memorial Hospital, is presented as the second financial statement in Appendix A.

Exhibit 2.3 Income statement, Chamberlin Skilled Nursing

	2012	**2011**
Revenues		
Skilled Medicare revenue	$3,754,548	$4,252,005
Private patient revenue	52,892	38,680
Ancillary services revenue	6,005,460	5,975,758
Other revenue	305,816	274,151
Gross patient services revenue	$10,118,716	$10,540,594
(less provision for doubtful accounts)	(22,956)	(31,007)
Net Revenues	$10,095,760	$10,509,587
Expenses		
Salaries and wages	$4,799,108	$4,960,685
Fringe benefits	864,934	897,288
Contract/registry labor	104,102	174,273
Physical therapy	899,920	836,363
Occupational therapy	821,152	781,753
Speech therapy	219,323	201,182
Pharmacy	555,302	800,304
Laboratory and other ancillary	278,708	294,999
Building and equipment rental	1,357,141	1,319,746
Depreciation expense	129,613	120,936
Interest expense	61,886	70,585
Total operating expenses	$10,091,189	$10,458,114
Net operating income (loss)	$4,571	$51,473
Net Nonoperating revenues	16,024	15,789
Net Income	$20,595	$67,262

Source: Author's calculations.

Revenues

Patient services revenues are earned by the healthcare organization through the provision of services and products related directly to patients. The level of detail of revenues presented on income statements varies among organizations. For Chamberlin, it was deemed material to present skilled Medicare revenue, private patient revenue, and ancillary services revenue separately. For larger organizations, it is common to present only the total of patient services revenue on the income statement and then to present the breakdown by payer, such as Medicare and Medicaid, or by type of service provided in the footnotes of the financial statements.

Contractual Allowances, Charity Care, and Doubtful Accounts

Internally to the accounting system, revenues may be recorded at the organization's full price listed on the chargemaster. However, two deductions from revenue occur behind the scenes. First, the billing system will include the expected payments of services corresponding to agreed charges, or agreed upon discounts from usual charges. Only the expected payments are counted as revenues. The differences between an organization's listed charges and the expected payments are called **contractual allowances**. If the chargemaster lists $150 as the price for a service, and the contract with an insurance company lists $100 as the payment for a service, the contractual allowance is $100. Contractual allowances do not appear on audited (GAAP) financial statements, although they do appear on reports provided to Medicare.

Second, the revenues associated with patients qualifying for charity care are deducted from total revenues. Healthcare organizations are expected to have a charity care policy and seek to identify patients who might qualify for charity care. When a patient qualifies, the healthcare organization does not send the patient a bill, and there is no expectation of revenue. An outline of the charity care policy as well as the amount of charity care based upon the estimated cost of providing the care are reported in a footnote of financial statements.

Analyze This

St. Francis Hospital, The Heart Center©, has the following section in its charity care policy: Patients without sufficient non-exempt assets qualify for 100% charity care if their family income is at or below 300% of the Federal poverty guidelines. Patients are responsible for 20 to 80% of their bill if their family income is between 300 and 400% of the Federal poverty guidelines. Please refer to the current charity care income guidelines for sliding scale eligibility percentages. Documentation and verification of income and assets will be requested during the application process.

Does this charity care policy seem fair to you?

Source: Catholic Health Services of Long Island (2013).

An annual total of uncollectable accounts, or doubtful accounts, is a third deduction from revenue that appears directly on the income statement. As with the estimated provision for uncollectable accounts that appears on the balance sheet, a portion of the estimate is based on historical patterns of payments. Uncollectable accounts also include a patient-by-patient accounting of whether or not the organization was paid.

Nonoperating Revenue

In addition to revenues earned from provision of services to patients, healthcare organizations may earn revenue from a number of services related to the patient experience. These other operating revenues include cafeteria sales, parking lot fees, and research revenues.

Further, healthcare organizations may earn revenue from services unrelated to the patient services experience. Earnings associated with nonoperating services are often presented as nonoperating income (nonoperating revenue less nonoperating expenses) as the details are not generally important. Sources of nonoperating income include earning on financial investments, interest income, and restricted gifts and donations.

Because not-for-profit organizations have limited sources of net assets as compared to investor-owned organizations, it is often observed that large not-for-profit organizations generate substantial earnings from nonoperating sources. As presented on Chamberlin Skilled Nursing's Income Statement (Exhibit 2.3), nonoperating income comprises a substantial portion of net income.

Analyze This

Is it a concern that most of the net income earned by Chamberlin Skilled Nursing in 2012 was derived from nonoperating income? Explain your reasoning.

Expenses

Expenses include the cost of services and goods used in the provision of patient care and administrative activity. Expenses are typically presented by the type of service that is involved, such as salaries and wages, and fringe benefits. For some organizations, either on the income statement or in the footnotes, expenses are presented by the area of business for the organization, including inpatient and outpatient expenses. The latter is particularly true for complex healthcare organizations that include many different areas of business like hospital services, nursing home services, and home health services.

The reporting of expenses for most services and goods represents an accounting of when services and goods are provided. Again, with accrual accounting, expenses represent the value of the services and goods used during an accounting period, not necessarily the expenditures that occurred during that same time period. For salaries, wages, and related expenses, accounting must recognize when employees are working, which can be complicated given the various types of overtime pay or differences in pay associated with working nights or weekends. For temporary workers provided through an agency and professional medical services provided by nonemployees (e.g., physical therapy, speech therapy), invoices for payment must include the dates of work.

Reporting of expenses for pharmacy, laboratory, and other ancillary services may be tied to the process that tracks use of services for billing purposes. The reporting of expenses associated with the general use of the facility and equipment requires additional analysis associated with the expenses. For building and equipment rental expenses, as well as interest expenses, the expense itself is typically associated with a specific time period. Even though attributing the expense of the building and equipment rental to particular patients can be a challenge, attributing the expense to a time period for purposes of preparing the income statement is not a challenge. For buildings and equipment that are purchased, recognition of the expenses over time comes from depreciation.

Depreciation Expense

The term **depreciation** as used by accountants refers to the recognition of the expense of using buildings and equipment over time. Long-term assets may be purchased with one payment or by payments on a loan or mortgage over time; in either case, the goal of accounting is to match the use of assets to the provision of services. There are several methods of depreciation available for businesses. Healthcare organizations predominantly use the **straight-line method of depreciation**. The straight-line method divides the purchase price by the number of years that an asset will typically be used, or its **useful lives**. To facilitate the accounting process for hospitals, nursing homes, and physician offices, the American Hospital Association (2013a) prepares an annual guide to the depreciation lives for medical and administrative assets, including desks and chairs. An example of types of useful lives is presented in Exhibit 2.4. A demonstration of the process of recording depreciation expenses for the income statement and the resulting values for the balance sheet is presented in Exhibit 2.5.

Exhibit 2.4 Useful lives of selected medical assets

Anatomical model	10 years
Arthroscopy instrumentation	3 years
Arthroscope	5 years
Apnea monitor	7 years
Audiometer	10 years
Biofeedback machine	8 years
Bronchoscope	3 years

Source: Author's calculations.

Exhibit 2.5 Depreciation schedule for an apnea monitor

Year	Depreciation Expense	Accumulated Depreciation	Book Value
Year 0—Purchase	$0	$0	$4,025
Year 1—Use	$575	$575	$3,450
Year 2—Use	$575	$1,150	$2,875
Year 3—Use	$575	$1,725	$2,300
Year 4—Use	$575	$2,300	$1,725
Year 5—Use	$575	$2,875	$1,150
Year 6—Use	$575	$3,450	$575
Year 7—Use	$575	$4,025	$0

Source: Author's calculations.

Analyze This

Chamberlin Skilled Nursing recorded depreciation expenses of $129,613 in 2012 and $120,936 in 2011. Why did the depreciation expense increase?

Gains and Losses

Gains and **losses** are earned from the sales of assets (or repayment of liabilities) at amounts that differ from those presented on the balance sheet. For example, say a healthcare organization purchased a new apnea monitor for a clinic in 2010 for $4,025. After two years, it had accumulated depreciation of $1,150 and had a net value on the balance sheet of $2,875.

The organization conducted a complete renovation and concluded that it no longer needed that particular machine. When the apnea monitor was sold, the organization received $2,000. Thus, the organization experienced a loss of $875 on the sale. Since the total of gains and losses is often not substantial, the net amount (gains minus losses) may be presented as a single line on financial statements. For Chamberlin Skilled Nursing, there were no gains or losses in the two years presented in Exhibit 2.3. For Hendrickson, there was a gain for paying off debt early, and gains and losses on disposal of equipment, as presented in Appendix A.

Provision for Taxes

It is perhaps well known that for-profit companies are expected to report the payment of income taxes, property taxes, and other nonpayroll taxes on the income statement. Perhaps less well known is that not-for-profit organizations may have income related to services that are not a regular part of the organization's activities. For example, a hospital may own a building that is primarily used for medical offices, but when they have an excess number of offices, they may lease them to nonmedical companies. The income earned from the nonmedical company leases is viewed as unrelated business income and is subject to taxes.

The income statement provides a summary of the transactions that occur during the accounting period. This information leads to the calculation of net income, which is the sum of the revenues and gains minus the expenses and losses. By focusing on revenues and expenses, the income statement focuses on the organization's operations. By following GAAP, it is possible to compare organizations in terms of their net income to assess profitability. Due to the nature of accrual accounting practices, the income statement might not provide all users with the information that they would like to have to assess the financial activity of an organization. Therefore a statement of cash flows is also provided.

For Review:

1. What is the general equation for the income statement?
   Net income = Revenues − Expenses + Gains − Losses

2. What are contractual allowances?
   Contractual allowances are the differences between an organization's listed charges and the expected payments from health insurance companies and other payers.

3. What is depreciation expense?
   Depreciation expense is recognition of the use of an asset over its life. By spreading out the expense associated with purchasing an asset over the number of years it can be used, organizations can better match revenues earned each year with expenses.

4. What is the difference between contractual allowances, charity care, and doubtful accounts?
   Contractual allowances reflect differences between charges and expected payments based upon contracts with insurance companies. Charity care represents care for which no charges are expected, which is measured at the cost of providing the service. Doubtful accounts represent care for which charges are made and for which an estimate of the amount that will not fully be collected is prepared.

2.5 Statement of Cash Flows

The **statement of cash flows** is a presentation of the sources and uses of cash balances of an organization over the time of an accounting period. The purpose of the statement of cash flows is to provide an explanation for the changes in cash (actually cash and cash equivalents) between two accounting periods. In providing this explanation, the statement of cash flows also reconciles the difference between the accrual account and cash accounting measures of financial performance.

The statement of cash flows for Chamberlin Skilled Nursing is presented in Exhibit 2.6. A more complicated statement of cash flows from Hendrickson Memorial Hospital is presented as the third financial statement in Appendix A.

Exhibit 2.6 Statement of cash flows, Chamberlin Skilled Nursing

	2012	2011
Net income	$20,595	$67,262
Change in:		
Depreciation	129,613	120,936
Prepaid items	5,071	1,089
Resident accounts receivable	38,384	64,891
Inventories	22,779	(15,236)
Accounts payable	(45,558)	(152,256)
Accrued payroll/related liabilities	(20,854)	165,827
Other accrued liabilities	26,976	(106,064)
Net cash provided (used) by operations	$177,006	$146,449
Cash flows from investing		
Purchase of depreciable assets		
Building	$23,243	$67,263
Equipment	28,074	(67,886)
Other fixed assets	14,702	0
Other noncurrent assets	(31,064)	5,177
Net cash provided (used) by investing	$34,955	$4,554
Cash flows from financing		
Mortgage notes	($30,696)	($343,839)
Notes payable	(64,972)	(78,079)
Net cash provided (used) by financing	($95,668)	($421,918)
Net increase (decrease) in cash	$116,293	($270,915)
Cash at beginning of period	$615,397	$912,856
Cash at end of period	$731,690	$615,397

Source: Author's calculations.

Cash Flow from Operations

The statement of cash flows is separated into three parts: cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities. Cash flow from operations starts with net income from the income statement. Adjustments for noncash expenses are added back to net income next, with the major adjustment typically being the depreciation expense. When long-term assets are purchased, an outflow of cash occurs (an investment activity as described in the next section). When expenses associated with the depreciation of long-term assets are recorded each year, they do not involve any use of cash, which is why depreciation is added back to net income. To fully reconcile the difference between accrual and cash accounting, changes in balance sheet items related to operating activities, primarily current assets and current liabilities, are also presented.

For example, at Chamberlin Skilled Nursing, resident accounts receivable (net of allowance for doubtful accounts of $18,000 in 2012 and $20,000 in 2011) decreased to $1,145,073 in 2012 from $1,183,457 in 2011. This decrease of $38,384 represents additional cash that must have flowed into the organization from patients and their insurance companies. In total, Chamberlin experienced positive cash inflows from operations far in excess of net income alone.

Cash Flow from Investing Activities

Cash flow from investing activities reflects purchases of physical plant assets (property, plant, and equipment) and sales of financial securities that are held as assets limited as to use or for other long-term purposes. For Chamberlin, the sale of equipment in 2012 was associated with cash inflows, and the purchase of equipment in 2011 was associated with cash outflows.

Cash Flow from Financing Activities

Cash flow from financing activities reflects obtaining funding and the repayment of funding from noncurrent sources. Bonds, mortgages, notes, or leases are sources of cash inflows when they are acquired and sources of cash outflows when they are repaid. It is valuable to observe that the payment of interest is recorded on the income statement and the repayment of principal balances is recorded on the statement of cash flows.

Net Income Versus Cash Flow

Again, one purpose of the statement of cash flows is to reconcile the difference between accrual account and cash accounting measures of financial performance. In other words, the income statement reflects accrual accounting methods and provides the value of net income earned. The statement of cash flows adds the inference of cash transactions to the income statement and balance sheet to provide the value of cash flow realized.

In the case of Chamberlin Skilled Nursing, operating, investing, and financing activities demonstrated positive net cash flows in excess of net income in 2012. However, in 2011, the effects of purchasing equipment and repaying mortgages and notes result in negative net cash flows that more than offset net income. Earning positive income is looked upon as a favorable measure of organizational performance. Net cash flows can be positive or negative depending on the range of activities without a clear indication of performance.

For Review:

1. What are the three sections of a statement of cash flows?
   The three sections of the statement of cash flows are cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities.

2. What is the difference between net income and net cash flow?
   Net income is the amount that an organization has earned from providing services and other activities during the year. Net cash flow is the change in cash held by the organization over the year. Depending on the level of investing and financing activities in the current year and prior years, net income and net cash flow can be very different, and both are important.

2.6 Activity Measures and Community Benefit Statement

The dollar values presented on formal financial statements can be useful to those involved with the management and governance of an organization and to lenders and other interested persons outside the organization. Still, the dollar values may not provide a complete picture of a healthcare organization. For this reason, activity measures and community benefit statements are prepared and made available to the public.

Activity Measures

Activity measures provide a more complete presentation of the transactions that occur during an accounting period. Since activity measures are not required by financial accounting principles, there are not definitions of which activity measures to present, nor are there uniform ways in which they are presented. The selection and presentation of activity measures is left to the judgment of management. The value of activity measures is that they enable users of financial statements to place the values on the balance sheet and income statement in context. Selected key activity measures for Chamberlin Skilled Nursing are presented in Exhibit 2.7.

Exhibit 2.7 Key activity measures, Chamberlin Skilled Nursing

	2012	2011
Licensed bed capacity	54	54
Total admissions	984	868
Total discharges	892	841
Medicare resident days	17,008	17,378
Private resident days	133	79
Other resident days	1,341	1,267
Total resident days	18,482	18,724
Occupancy rate	93.8%	95.0%
Registered nurses	18	24
Turnover rate	48%	57%
Licensed practical nurses	8	12
Turnover rate	50%	76%
Nurse aides	129	133
Turnover rate	39%	93%

For the management of a skilled nursing facility, key activity measures include the number of residents, the number of resident days, and the number and turnover rates of key nursing personnel. Chamberlin experienced an increase in the number of admissions and discharges in 2012 as compared to 2011 and a slight reduction in the number of patient days of care. This means that there were slightly shorter lengths of stay for patients in 2012. The numbers of nurses in each category were lower at the end of 2012 as compared to 2011. Also of note, the turnover rate (the percentage of nurses who left the organization during the year) was lower for every category of nurse, and markedly lower for nurse aides.

Analyze This

Does Chamberlin Skilled Nursing employ enough nurses to provide good quality patient care? What information would you need to possess to provide a good answer to this question?

Community Benefit Statement

The IRS, and many states, now requires certain not-for-profit healthcare organizations to provide a **community benefit statement**. This statement is a listing of the activities that benefit the community and the costs and any offsetting revenues associated with these services. Under the Patient Protection and Affordable Care Act, there are new standards for not-for-profit hospitals to meet to maintain tax-exempt status. IRS Form 990, Schedule H lists specific categories of community benefits for reporting. However, even before the Affordable Care Act, some states had gone further to require community benefit statements (Somerville, Nelson, & Mueller, 2013).

There has not been a standard format for public presentation of these statements as there is for financial statements. However, with the revisions to the IRS Form 990, Schedule H, its format now appears to be broadly adopted for public presentation. To prepare a community benefit statement, it is first necessary to define and describe the community served by the healthcare organization. Second, it is expected that a community benefit planning process will occur, including a community health needs assessment. Third, measurable objectives and timelines must be prepared to assure consistent and accurate reports. Finally, a report can be prepared that includes financial measures of community benefits as well as unquantifiable measures. The key figure from Bixby Health System's Community Benefit Statement for 2012 is presented in Exhibit 2.8.

Exhibit 2.8 Community benefit statement, Bixby Health System, 2012

	Expense	Offsetting Revenue	Net Benefit
Direct individual benefits			
Financial assistance for persons in poverty	$4,966,936	$0	$4,966,936
Medicaid services	90,843,186	91,402,850	(559,664)
Medicare services	65,413,256	60,197,727	5,215,529
Community services			
Community benefit operations	401,910	0	401,910
Community building activities	22,145	0	22,145
Community health improvement services	548,879	71,221	477,658
Financial and in-kind contributions	1,521,854	40,661	1,481,193
Subsidized health services	3,024,357	0	3,024,357
Total community benefit	$166,742,523	$151,712,459	$15,030,064

Source: Author's calculations.

In Bixby's statement, benefits are provided to individuals in need, as defined as persons in poverty, persons qualified for Medicaid and Medicare coverage, and the community as a whole. All direct and community services are measured at costs, not charges. It is informative to managers and other interested parties that Bixby may be losing money on Medicaid services and earning a profit on Medicare services. This information may be used to examine the efficiency in the provision of services to all patients. Further, it may be useful to boards of directors and others who assess whether an organization is meeting its mission by providing medical services to specific populations and other services to the community.

For Review:

1. Who benefits from healthcare organizations' community benefits?
   For certain community benefits, specific individuals benefit by receiving financial assistance or services covered by Medicaid or Medicare. For other community benefits it is the community broadly defined, not clearly defined individuals, that benefits.

Summary & Resources

Chapter Summary

This chapter has covered a substantial amount of material on the role and function of financial accounting in healthcare organizations. Preparation of complete and accurate financial accounting reports requires involvement in almost every aspect of the operations of a healthcare organization. Financial statements are used for managerial purposes by people within the organization and for evaluation purposes by outside the organization. Given the widespread use of financial statements and the public interest in accuracy, the preparation and presentation of financial statements is tightly regulated.

The three main financial statements include the balance sheet, the income statement, and the statement of cash flows. The balance sheet presents a listing of the assets held by an organization, the liabilities (debts) owed to others, and the net of the assets minus the liabilities at a specific point in time. It presents physical assets at their purchase price, which is not necessarily a perfect measure of value, but it can be consistently and accurately reported. Financial assets are reported at their current market value. Both current assets and current liabilities are highlighted to provide information on the short-term status of the organization. Also highlighted for not-for-profit organizations are restrictions that may be placed on assets due to decisions by the board of directors or donors. These restrictions may lead to keeping track of assets and net assets by the fund upon which it is based.

The income statement lists the revenues earned by the organization, the expenses incurred, and the net income that remains. In many not-for-profit healthcare organizations, the income statement is alternatively called a statement of operations or a statement of revenues and expenses. This statement is the key source of information on the sources and level of profitability for the organization.

In addition to the measurement of profitability on the basis of the income statement, the statement of cash flows measures where actual dollars flowed in and out of the organization. Three types of cash flows are presented in the statement of cash flows: operating activities, investing activities, and financing activities. Net income is the starting point for the statement of cash flows, which then presents the reasons for the change in the level of cash available for the organization being different from net income, with each reason involving how accounting is conducted under accrual rules that match revenues and expenses, rather than a simple calculation of receipts of money and expenditures.

Discussion Questions

1. Healthcare organizations generally follow the steps in the accounting cycle and adhere to accepted accounting principles. Are persons in the community really concerned with healthcare organizations' financial accounting practices, or do they just want to receive good quality medical services? Is consistency all that important?
2. Many small physician offices have only one person who submits bills to insurance companies and records and deposits the checks when bills are paid. It doesn't make sense to hire more persons to comply with good practices for internal controls. If you don't trust the finance person, can't you just fire them?
3. How can a healthcare organization have a positive net income, yet have no money? What can be done to remedy this situation?
4. How can healthcare organizations earn revenues, other than providing services to patients? From Exhibit 2.3, it appears that in 2012 Chamberlin Skilled Nursing earned $4,571 from operations and $16,024 from other sources. Should Chamberlin cease operations to focus on earning money from other sources?

Exercises

1. The balance sheet for 2012 at Sheldon Clinic is presented in Exhibit 2.9. Unfortunately, the elements are presented in alphabetical order instead of the appropriate accounting format. Rearrange the rows to put them in the correct order.

Exhibit 2.9 Balance sheet for Sheldon Clinic, December 31, 2012

Accounts payable	$588,899
Accounts receivable	$2,516,631
Accrued expenses	$372,561
Accumulated depreciation	$4,422,702
Allowances for uncollectible accounts	$298,740
Assets limited as to use	$4,440,081
Cash and cash equivalents	$1,473,975
Fixed assets	$10,061,440
Loans and notes payable	$1,567,857
Long-term liabilities	$3,351,761
Net accounts receivable	$2,217,891
Net fixed assets	$5,638,738
Other current assets	$100,014
Pharmaceutical inventories	$696,615
Restricted net assets	$4,588,430
Short-term investments	$1,038,172
Total assets	$15,605,486
Total current assets	$5,526,667
Total current liabilities	$2,529,316
Total liabilities	$5,881,077
Total liabilities and net assets	$15,605,486
Total net assets	$9,724,408
Unrestricted net assets	$5,135,979

2. The Income statement for 2012 at Sheldon Clinic is presented in Exhibit 2.10. Unfortunately, the elements are presented in alphabetical order instead of the appropriate accounting format. Rearrange the rows to put them in the correct order.

Exhibit 2.10 Income statement for Sheldon Clinic, December 31, 2012

Medicaid revenue	$8,362,905
Depreciation expense	$567,040
Interest expense	$1,073,674
Lease expense	$449,582
Miscellaneous nonpatient revenue	$567,633
Net income or (loss)	$1,938,226
Net patient revenues	$22,422,749
Operating income	$1,370,593
Other government revenue	$5,555,873
Private insurance revenue	$8,503,972
Professional services	$3,154,713
Salary and fringe benefits expense	$14,335,919
Supplies and other operating expense	$1,471,228
Total operating expense	$21,052,156

3. Following the amounts set in the chargemaster at Sheldon Clinic, $140,000 in bills were processed for private insurance patients in December 2012. Of these bills, $20,000 is associated with patients who qualify for 100% charity care. For the remaining patients, if the usual rate of contractual allowances is 25%, how much would Sheldon Clinic list as revenues for the month of December 2012?
4. Continuing with Exercise 2, if 10% of patient bills are expected to be uncollectable, how much would Sheldon Clinic list at revenues for the month of December 2012?
5. Sheldon Clinic purchased new equipment for an examination room. The cost of the equipment is $24,000 and has a useful life of eight years. Using the straight-line deprecation method, what is the annual depreciation expense for the equipment? Prepare a depreciation schedule of the equipment for the clinic.

Key Terms

accounting period The time period covered by a financial statement, usually being a month, quarter, or year.

accrual accounting The practice of recording expenses and revenues when services are provided to patients rather than when cash transactions occur.

adjusting entries Transactions that are entered into the accounting process to recognize changes in values that are not due to specific events.

assets Physical or financial items that can be owned and facilitate the operations of an organization. Current assets are those assets that are in the form of cash or cash equivalents or that are expected to be in the form of cash within one year.

assets limited as to use Assets that have restrictions on their use that were imposed by the organization itself or by an outside lender or donor. Assets limited as to use are often held in the form of financial assets.

balance sheet A presentation of the assets, liabilities, and net assets of an organization at a point in time.

basic accounting equation
Assets = Liabilities + Net assets.

cash accounting The practice of recording revenues when payments are received and recording expenses when supplies and resources are purchased.

chart of accounts A listing of accounts that organizations use to record transactions. Each type of transaction must be recorded in an account, with subaccounts made available to record the details associated with transactions.

close the books The process of stopping changes to accounts for the time period covered by the financial statements and then making entries that mark the end of the time period.

community benefit statement A statement that lists the services provided by the organization that furnish a benefit to the community, either through provision of healthcare services to defined populations or services that benefit the community as a whole. Community benefits are valued at costs, not charges.

comparability An accounting principle that expenses should be recorded in the same time period as the revenues that caused the expenses to be generated. For assets that are used over several time periods, depreciation is required.

conservatism An accounting principle that if there is any doubt or possible bias in transactions, the organization should not overstate assets or net income.

consistency An accounting principle that organizations are expected to use the same recording and reporting methods in each accounting period.

contractual allowances The differences between an organization's listed charges and the expected payments from health insurance companies and other payers.

cost The sum of the expenses associated with a service; also, a constraint on adherence to accounting principles, whereby the value of recording and reporting financial information must be weighed against the resources associated with the recording and reporting process.

current assets Assets that are cash or are expected to be converted into cash within a year.

current liabilities Liabilities that are expected to be paid within a year.

depreciation Recognition of the expense of using buildings and equipment over time to match when they are used to provide services to patients.

doubtful accounts The dollar value of uncollected bills from patients and third-party payers, also called bad debts.

entity The company or organization that is the subject of a financial statement.

equity The term for net assets used by investor-owned organizations; what the organization owns after all the bills have been paid.

expenses The costs of services and goods used in the provision of patient care and administrative services during an accounting period.

full disclosure An accounting principle that all transactions are reflected in financial statements.

fund accounting Not-for-profit organizations are unique in that they may present net assets as a set of funds reflecting the restrictions placed upon certain assets.

fund balance The value of the organization's assets after subtracting the value of the liabilities. The more commonly accepted term for fund balance on balance sheets of not-for-profit organizations is net assets.

gains Amounts earned by selling assets for more than the purchase price less any depreciation.

going concern An assumption in financial accounting that the organization being reported upon in the financial statements is expected to be in existence for the foreseeable future.

income statement A presentation of the revenues, expenses, and net income of an organization over the time of an accounting period. The income statement may also be called the statement of operations or the statement of revenues and expenses.

internal controls The process by which an organization assures the accurate and consistent recording of transactions and reporting of results.

journal entry The initial recording of a transaction in an account, with *journal* being another term for an account.

liabilities The amounts owed by the organization to other businesses or individuals.

long-term assets Assets that are not in the form of cash and are not expected to be sold during the current year.

long-term liabilities The amounts owed by the organization to other businesses or individuals that do not have to be paid in the current year.

losses Amounts lost by selling assets for less than the purchase price less any depreciation.

materiality A test of whether an error in recording or reporting results in a significant misinterpretation of an organization's financial status.

net assets The value of the organization's assets after subtracting the value of the liabilities. In some presentations of balance sheets of not-for-profit organizations, net assets may be presented as fund balance. In presentations of balance sheets of for-profit organizations, net assets may be presented as owner's equity.

nonoperating revenue Revenue earned from activities not directly related to the main purpose of the organization.

objectivity An accounting principle of recording transactions based upon evidence and independent of bias.

posting to a ledger The step of recording transactions to accounts in a summary manner.

preadjusted trial balance An intermediate step in the accounting process that checks that transactions have been properly recorded.

prepaid expenses Current assets that represent advance payment of amounts that will be treated as expenses.

relevant An accounting principle of reporting summaries of transactions that are meaningful to users.

reliability An accounting principle of recording transactions in an accurate and complete manner.

revenues The amounts earned through the provision of services and products, with the amounts being recorded at the level of payment agreed upon from a third-party payer or the level expected from individuals or companies.

statement of cash flows A presentation of the sources and uses of cash balances of an organization over the time of an accounting period; it is divided into sections for operating activities, investing activities, and financing activities.

straight-line method of depreciation Recording the expense associated with use of a long-term asset by dividing the purchase price by the number of years the asset will be used.

unrestricted fund (general fund) Net assets associated with the operations of the organization.

useful lives The number of years that assets are expected to be available and functioning. This number is used for recording depreciation expense.

Suggested Websites

- For an example of a full chart of accounts for hospitals, see California's Office of Statewide Health Planning and Development: http://www.oshpd.ca.gov/hid/Products/Hospitals/AnnFinanData/Manuals/index.html
- For information on financial accounting standards and the public accounting profession, see American Institute of Certified Public Accountants (AICPA): http://www.aicpa.org
- For information on financial accounting standards, see Financial Accounting Standards Board (FASB): http://www.fasb.org
- For information on accounting practices and the healthcare financial management profession, see Healthcare Financial Management Association (HFMA): http://www.hfma.org
- Internal Revenue Service: Form 990, Return of Organization Exempt From Income Tax, http://www.irs.gov/uac/Form-990,-Return-of-Organization-Exempt-From-Income-Tax-, Schedule H, http://www.irs.gov/pub/irs-pdf/f990sh.pdf