Corrections Sheet

Introduction to the Financial Management of Healthcare Organizations
Seventh Edition

by Michael Nowicki

After the book's first printing, the financial statements in chapter 3 were modified to improve the articulation between years and between statements. (Thanks to Dana Forgione, PhD, CPA, CMA, CFE, professor of accounting at the University of Texas at San Antonio, for his assistance in improving these financial statements). The revised statements also affect a few practice problems and solutions. The author apologizes for any inconvenience.

To determine whether you have the first printing of the book or a later one that includes the revised financial statements, look at the copyright page (preceding the dedication page near the front of the book). Just above the middle of the page you will see a row of numbers. If the rightmost number is a 1, you have the first printing; if not, you have a later (corrected) printing.

Here is a list of the revised pages, which are also appended to this correction sheet as PDFs:

Page 52	In exhibit 3.1, many numbers were changed; the "Permanently restricted net assets" row was deleted; and some descriptive entries in the left column were slightly reworded and/or indented differently.
Page 55	In exhibit 3.2, some numbers were changed; several rows in the "REVENUES" and "CHANGES IN NET ASSETS" sections were deleted; a new row ("Estimated bad debt expense") was added to the "EXPENSES" section; and some descriptive entries in the left column were reworded and/or indented differently.
Page 56	The first italicized sentence of the first full paragraph was deleted.
Page 59	Exhibit 3.3 was almost entirely replaced, though its basic organization was retained ("*Cash flow from operating activities*," etc.).
Page 60	In exhibit 3.4, sections 2, 3, and 4 were slightly reworded, including some new numbers, and the "Bad Debt" section was moved to the end.
Pages 71–73	In the Ratio Analysis Practice Problem Solution, many numbers were changed.
Page 389	In the Ratio Analysis Self-Quiz Solution, several numbers were changed.

EXHIBIT 3.1
Bobcat Hospital Balance Sheet as of December 31, 2016 and 2017 (in thousands)

	2017	2016
ASSETS		
Current assets		
Cash	$ 124	$ 280
Temporary investments	45	30
Receivables, net	3,536	2,860
Inventory	175	140
Prepaid expenses	32	40
Total current assets	3,912	3,350
Noncurrent assets		
Land, plant, and equipment	6,980	6,580
Less accumulated depreciation	1,730	1,259
Plant and equipment, net	5,250	5,321
Long-term investments	609	790
Other noncurrent assets	113	109
Total noncurrent assets	5,972	6,220
Total assets	9,884	9,570
LIABILITIES AND NET ASSETS		
Current liabilities		
Accounts payable	$ 302	$ 370
Notes payable	345	335
Accrued expenses payable	871	606
Deferred revenues	10	15
Estimated third-party adjustments	137	224
Current portion of long-term debt	184	178
Total current liabilities	1,849	1,728
Noncurrent liabilities		
Long-term debt, net of current portion	3,600	3,500
Total liabilities	5,449	5,228
NET ASSETS		
Unrestricted net assets	3,283	3,190
Restricted net assets	1,152	1,152
Total net assets	4,435	4,342
Total liabilities and net assets	$9,884	$9,570

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EXHIBIT 3.2
Bobcat Hospital Statement of Operations (in thousands) through December 31, 2016 and 2017

	2017	2016
REVENUES		
Net patient services revenue	8,402	8,119
Premium revenue on sponsored health plans	400	0
Other operating revenue	440	447
Total operating revenue	$ 9,242	$ 8,566
EXPENSES		
Salaries, wages, and benefits	4,980	4,278
Supplies, drugs, and purchased services	3,080	2,956
Estimated bad debt expense	600	500
Depreciation expense	471	443
Interest	113	109
Total operating expenses	9,244	8,286
OPERATING INCOME	(2)	280
NONOPERATING INCOME		
Investment income	$ 95	$ 85
EXCESS OF REVENUE OVER EXPENSES	93	365
CHANGES IN NET ASSETS		
Add: Unrestricted net assets January 1	3,190	2,825
Unrestricted net assets December 31	3,283	3,190

revenue include amounts deducted from total charges to account for contractual allowances and charity care.

Net patient services revenue is money generated by providing patient care minus the amount the organization will not collect as a result of discounting charges per contractual agreement and providing charity care. For financial reporting purposes, patient services revenue does not include provisions for charity care because charity care was never intended to result in cash flow. GAAP in 2010 required that organizations report the amount of charity care recorded at cost along with the method of determining cost and the organization's

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charity care policy in notes to the financial statements. (*Bad debt* is the accounting recognition of how much money the organization has billed but will not collect; the amount reported must be based on charges. Bad debt should not be confused with charity care. ***Bad debt expense*** reflects the amount for which the organization provided services with the expectation of payment. *Charity care* reflects services the organization provided with no expectation of payment.)

In 2012 GAAP moved bad debt from an operating expense to a deduction of revenue to account for the patient's inability to pay deductibles for high-deductible health policies (which the organization knows at time of service). In 2016 the AICPA Revenue Recognition Task Force for Healthcare proposed, but did not require, new guidance for presenting bad debt. After recording revenue at the amount the organization expects to be paid, bad debt would then be recognized in two categories: *classic bad debt* (the organization believes the patient is able to pay, but the patient does not pay) would be recorded as a bad debt expense under operating expenses; and an *implicit price concession* (the organization believes the patient is unable to pay, but the patient is not eligible for charity care, and the organization recognizes a write-off based on internal policy). The proposed new guidance for presenting bad debt would allow organizations to group patients with similar characteristics, such as true self-pay or high deductible (Connor and Mosrie 2016).

Premium revenue is money generated from capitation arrangements that must be reported separately from patient services revenue because premium revenue is earned by agreeing to provide care, regardless of whether care is ever delivered. ***Other operating revenue*** is money generated from services other than health services to patients and enrollees. It may include revenue from rental equipment and office space, sales of supplies and pharmaceuticals, cafeteria and gift shop sales, and so on. Often the test for whether revenue is considered other operating revenue or nonoperating revenue is whether the revenue was generated in support of the organization's mission statement. Why is it important to distinguish between operating and nonoperating revenue? Because for a not-for-profit hospital, income derived from operations is not taxed, but income from unrelated businesses, such as the gift shop, may be taxed as unrelated business income. ***Net assets released from restrictions used for operations***, while not reflected in Bobcat Hospital's statement of operations, consist of money previously restricted by donors that has become available for operations.

expenses
Amounts of resources used by the organization.

Expenses are the amounts of resources used by the organization. The category of ***operating expenses*** represents resources used on operations to generate revenue in support of the organization's mission statement. These expenses can be listed by functional classification (organizational division), such as nursing department and support department, which is useful for internal purposes, or by natural classification, under such categories as *salaries, wages, and benefits* or *supplies, drugs, and purchased services*, as is the case with Bobcat Hospital's statement of operations, which is useful for external purposes.

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Exhibit 3.3
Bobcat Hospital Statement of Cash Flows, 2017

Cash flow from operating activities	
Excess of revenues over expenses for the year	$ 93
Adjustments to reconcile change in net assets to net cash	
Add:	
Depreciation expense	471
Decrease in prepaid expense	8
Increase in notes payable	10
Increase in accrued expenses payable	265
Increase in current portion of long-term debt	6
Less:	
Increase in temporary investments	(15)
Increase in patient accounts receivable (net of allowance for doubtful accounts)	(676)
Increase in inventory	(35)
Decrease in accounts payable	(68)
Decrease in deferred revenues	(5)
Decrease in estimated third-party adjustments	(87)
Net cash flow from operating activities	(33)
Cash flow from investing activities	
Purchasing of property, plant, and equipment	(400)
Proceeds from sale of long-term investments	181
Purchase of other noncurrent assets	(4)
Net cash flow from investing activities	(223)
Cash flow from financing activities	
Proceeds from issuance of long-term debt	100
Net cash flow from financing activities	100
Net increase (decrease) in cash for the year	(156)
Add: Cash balance at January 1	280
Cash balance at December 31	$ 124

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EXHIBIT 3.4
Bobcat Hospital Notes to Financial Statements, 2017

1. **Organization and Nature of Operations**
   Bobcat Hospital is a 120-bed, nonprofit hospital offering the following services: inpatient, outpatient, emergency, long-term, rehab, and home care.
2. **Community Benefit and Charity Care**
   Bobcat Hospital provides healthcare services through various programs that are designed to enhance the health of the community. Bobcat Hospital provides emergent and urgent care to persons who cannot afford health insurance because of inadequate financial resources. Bobcat Hospital's financial assistance policy provides care to patients regardless of their ability to pay, and all uninsured patients are eligible for discounts based on their income up to 400% of the federal poverty level. The amount of charity care provided is based on this policy, and the cost of charity care is calculated based on the charges for such services multiplied by the hospital's cost-to-charges ratio. The cost of charity care provided in 2017 was $420,000, and the amount for 2016 was $408,000. Not included in this amount, but still considered a community benefit, is the loss to the Medicaid program.
3. **Net Patient Services Revenue**
   Patient services revenue is reported at estimated net realizable amounts for services rendered. The amount is net of provisions for contractual allowances of $4,629,000 for 2017 and $4,491,000 for 2016. Provisions for contractual allowances recognized discounts provided based on agreements with Medicare, Medicaid, other government programs, and major insurance companies.
4. **Bad Debt**
   The amount of bad debt is based on the GAAP principle of revenue recognition. The amount recognized in 2017 was $600,000 based on charges, and the amount for 2016 was $500,000 based on charges.

RATIO ANALYSIS

ratio
A comparison between two or more financial facts, such as income to assets or assets to liabilities.

A **ratio** is a comparison between two or more financial facts, such as income to assets or assets to liabilities. Ratios are useful because they help an organization compare a period's results to previous periods or to the results of other, similar organizations.

Ratios emerge from facts located on the financial statements, which report an organization's financial position at a point in time and its financial operations over a period of time. Investors and creditors analyze financial statements, primarily through ratio analysis, to predict future earnings and the ability to service debt. Managers use ratio analysis to predict the future and to plan strategies that will influence the future. Financial statement analysis concentrates on four classifications of ratios: liquidity, profitability, asset efficiency, and capital structure (see exhibit 3.5 for Optum medians for all hospitals reporting in 2017 for 2015 fiscal years).

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Ratio Analysis Practice Problem Solution

Current ratio

$$\frac{\text{Total current assets}}{\text{Total current liabilities}} = \frac{\$3{,}350}{\$1{,}728} = 1.939$$

Collection period ratio

$$\frac{\text{Net receivables}}{\text{Net patient service revenue/365}} = \frac{\$2{,}860}{\$8{,}119/365} = 128.597$$

Days cash on hand, all sources, ratio

$$\frac{\text{Cash + Temporary investments + Unrestricted long-term investments}}{\text{(Total expenses – Depreciation expenses)/365}}$$

$$= \frac{\$280 + \$30 + \$790}{(\$8{,}286 - \$443)/365} = 51.191$$

Days cash on hand, short-term sources, ratio

$$\frac{\text{Cash + Temporary investments}}{\text{(Total expenses – Depreciation expense)/365}} = \frac{\$280 + \$30}{(\$8{,}286 - \$443)/365} = 21.488$$

Average payment period ratio

$$\frac{\text{Total current liabilities}}{\text{(Total expenses – Depreciation expense)/365}} = \frac{\$1{,}728}{(\$8{,}286 - \$443)/365} = 80.417$$

Operating margin ratio

$$\frac{\text{Operating income}}{\text{Total operating revenue}} \times 100 = \frac{\$280}{\$8{,}566} \times 100 = 3.269\%$$

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PRACTICE PROBLEMS AND SELF-QUIZZES

Total margin ratio

$$\frac{\text{Excess of revenues over expenses}}{\text{Total operating revenue}} \times 100 = \frac{\$365}{\$8{,}566} \times 100 = 4.261\%$$

Return on net assets ratio

$$\frac{\text{Excess of revenue over expenses}}{\text{Total net assets}} \times 100 = \frac{\$365}{\$4{,}342} \times 100 = 8.406\%$$

Total asset turnover ratio

$$\frac{\text{Total operating revenue + Other income}}{\text{Total assets}} = \frac{\$8{,}566 + \$85}{\$9{,}570} = 0.904$$

Age of plant ratio

$$\frac{\text{Accumulated depreciation}}{\text{Depreciation expense}} = \frac{\$1{,}259}{\$443} = 2.842$$

Fixed asset turnover ratio

$$\frac{\text{Total operating reveune + Other income}}{\text{Net fixed assets}} = \frac{\$8{,}566 + \$85}{\$6{,}220} = 1.391$$

Current asset turnover ratio

$$\frac{\text{Total operating revenue + Other income}}{\text{Total current assets}} = \frac{\$8{,}566 + \$85}{\$3{,}350} = 2.582$$

Inventory turnover ratio

$$\frac{\text{Total operating revenue + Other income}}{\text{Inventory}} = \frac{\$8{,}566 + \$85}{\$140} = 61.793$$

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Net assets financing ratio

$$\frac{\text{Total net assets}}{\text{Total assets}} \times 100 = \frac{\$4{,}342}{\$9{,}570} \times 100 = 45.371\%$$

Long-term debt to capitalization

$$\frac{\text{Long-term debt}}{\text{Long-term debt} + \text{Net assets}} \times 100 = \frac{\$3{,}500}{\$3{,}500 + \$4{,}342} \times 100 = 44.631\%$$

Debt service coverage ratio

$$\frac{\text{Excess of revenues over expenses} + \text{Interest expense} + \text{Depreciation}}{\text{Interest} + \text{Principal payments}}$$

$$= \frac{\$365 + \$109 + \$443}{\$109 + \$69} = 5.152$$

Note: $178 – $109 = $69

Cash flow to debt ratio

$$\frac{\text{Excess of revenues over expenses} + \text{Depreciation}}{\text{Current liabilities} + \text{Long-term debt}} \times 100$$

$$= \frac{\$365 + \$443}{\$1{,}728 + \$3{,}500} \times 100 = 15.455\%$$

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APPENDIX

ANSWERS TO SELF-QUIZZES

Chapter 3

Ratio Analysis

Current ratio = 2.116—better, good to benchmark

Collection period ratio = 153.611—better, poor to benchmark

Days cash on hand, all sources, ratio = 32.369—worse, poor to benchmark

Days cash on hand, short-term sources, ratio = 7.031—worse, poor to benchmark

Average payment period ratio = 76.928—better, good to benchmark as long as credit is not affected

Operating margin ratio = (0.022%)—better, poor to benchmark

Total margin ratio = 1.006%—better, poor to benchmark

Return on net assets ratio = 2.097—better, poor to benchmark

Total asset turnover ratio = 0.945—better, poor to benchmark

Age of plant ratio = 3.673—worse, good to benchmark

Fixed asset turnover ratio = 1.563—better, poor to benchmark

Current asset turnover ratio = 2.387—better, poor to benchmark

Inventory ratio = 53.354—worse, poor to benchmark

Net asset financing ratio = 44.870—worse, poor to benchmark, though nondirectional

Long-term debt to capitalization ratio = 44.804—worse, poor to benchmark

Debt service coverage ratio = 3.679—better, poor to benchmark

Cash flow to debt ratio = 10.351—better, poor to benchmark