Second Edition

HOSPITAL FINANCIAL ACCOUNTING

Theory and Practice

L. VANN SEAWELL, CPA, DBA

HEALTHCARE FINANCIAL MANAGEMENT ASSOCIATION

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To JOY . . .

She lights up my life.

Preface to the Second Edition

Strong winds of change have swept across the healthcare industry over the last two decades. Today, the winds of change are increasing in force, with no indication of abatement in the near future. Major adjustments have been made in the organization, operation, and management of the healthcare system, and even more drastic changes are yet to come. Charge-based, cost-based, and per diem payment mechanisms are being discarded. It is likely that the prospective payment system based on diagnosis related groups (DRGs) soon will give way to an arrangement providing for payment on a capitation basis. Hospitals, facing increasing competition for patients, will find themselves in a price war. Much greater emphasis will be given to marketing and public relations. The number of hospital acquisitions and mergers will increase rapidly. Hospitals that are not cost efficient will be forced to close.

Now, more than ever before, there is a need for continued improvement in hospital accounting and financial management. Every effort should be made to upgrade the accounting process so that it produces relevant and reliable information for managerial decision-making purposes. Only through the intelligent utilization of accounting information can hospital managers hope to deal successfully with the new problems and issues that are certain to emerge in the next decade and beyond.

This book is yet another installment in the Healthcare Financial Management Association's long history of educational programs. It is designed primarily for use by students of hospital accounting and finance in courses of an intermediate character, but it also should be useful for general reference purposes to anyone interested in the accounting and financial practices of hospitals. Although major emphasis is given to accounting theory and procedure, an attempt has been made throughout this book to deal also with related financial management considerations.

I sincerely appreciate the favorable response to the first edition of this book. Many readers have offered suggestions for improvements, and I have incorporated many of those recommendations in this edition, while retaining most of the basic features of the previous edition. All questions, exercises, and problems have been updated and revised where necessary. A substantial number of new exercises and problems have been added. Major sections of text of each chapter have been revised in an attempt to improve clarity and to cover recent developments. Two new chapters appear in this edition: (1) Chapter 18, which deals with leases and pension plans, and (2) Chapter 21, which provides a detailed discussion of the statement of changes in financial position. The Glossary has been expanded to include many additional terms. As was the case with the first edition, an Instructor's Manual is available to those teachers who adopt this textbook for their courses.

I could not have written this book without the help of a large number of people. While I wish to acknowledge their valuable and generous assistance, I dare not try to list all of them by name here. I fear that I might inadvertently overlook some who should be recognized in this way. Yet, I must single out several individuals to whom I owe a special debt of gratitude for whatever there may be of value and importance in

this writing. None of the people or organizations referred to here, however, have the slightest responsibility for any errors of commission or omission which may appear within these pages. Such responsibility is entirely mine.

I wish to list the names of Louis Block, Ray Everett, Sister Mary Gerald, Harold Hinderer, Henry Hottum, Herman Kohlman, Charlie Mehler, Ralph Miller, Bill Mueller, Bob Penn, Stan Pressler, Bob Schultze, Bob Shelton, John Stagl, and Jeff Steinert who shared their great knowledge of the hospital business with me over many years. They also gave me their friendship, encouragement, and fond memories which I shall always treasure.

A special note of appreciation is extended to Mike Doody, Ron Keener, and Ron Kovener whose kindness, patience, and understanding meant so much to me when I was traveling through troubled waters.

Finally, I particularly want to thank the people of the hospital industry to whom I feel an obligation that is beyond my ability to repay.

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Bloomington, Indiana
August, 1986

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PART 1

Basic Concepts, Principles, and Procedures

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Hospital Management and Accounting

The United States spends more of its gross national product (around 11 percent) on healthcare than any other nation in the world. Healthcare is easily the nation's second largest industry, after construction, with expenditures running at more than $400 billion per year and growing by almost 13 percent annually. Although the healthcare system in the United States has numerous strengths and is far superior to that of any other country, it is argued by some that many Americans do not receive the healthcare services they need while many others receive more healthcare services than necessary. Consequently, the healthcare business continues to be the target of greatly increased public attention, criticism, and controversy concerning its efficiency in managing the huge investment the American people are making in it.

This paradox, often headlined as the "healthcare crisis," is not a single problem, nor is it solvable simply through the expenditure of more money and manpower. Some of the factors involved include financial barriers, weaknesses in the organization of existing healthcare delivery systems, competitive pressures arising from changes in the demand for a variety of healthcare services, unsound financing methods, reimbursement limitations by third-party payers, and changes in medical technology requiring expensive equipment and highly skilled personnel. A satisfactory solution to the many problems involved in the provision of healthcare services has a number of elements, but one can be certain that major emphasis must be given to continued improvement in the efficiency with which healthcare resources are managed. It is to this requirement of more effective accounting and financial management that this book is addressed.

In this book, attention is focused on hospitals, the major component of the healthcare industry. Hospital services currently account for about 40 percent of the healthcare dollar. Today, the nation's 7,000 hospitals have an overall occupancy rate averaging around 67 percent for 1.4 million beds. Annual volume of service at present exceeds 9 million inpatient admissions with a 6.5 day average length of hospital stay and 64 million outpatient visits. Annual spending for patient care is more than $150 billion, compared to only $2 billion in 1946. Hospitals now employ some 4 million persons, compared to 830,000 in 1946, at a payroll cost of some $62 billion per year, which represents about 50 cents of each dollar of operating expenses. Assets per bed vary according to the type of hospital, but the figure averages to about $60,000, compared to $15,000 in 1960. Current per bed construction costs for a new community hospital are in excess of $70,000.

In this era of rapidly rising costs and changes in the socioeconomic environment in which hospitals must function, the financial problems of hospitals have become numerous, severe, and indescribably complex. Indeed, of the many types of modern enterprises, it is difficult to find one whose management offers a greater challenge than does today's hospital. The provision of hospital healthcare services at reasonable costs is an enormously difficult business that requires the fullest application possible of advanced

accounting and financial management principles and techniques. Hospital administrators, financial officers, and other members of the hospital management team, in striving for maximum efficiency in the utilization of increasingly expensive and scarce resources, have long since discovered that a high order of accounting is an essential prerequisite to effective financial management. It is this necessary marriage of management with accounting that provides the theme of this book.

THE HOSPITAL CORPORATION

In the United States today, there are more than 7,000 hospitals. Some 5,900 of these are short-term, general hospitals widely referred to as community hospitals. Of these, about 1,700 are government-owned and 800 are proprietary (investor-owned) hospitals. The remaining 3,400 hospitals, 58 percent of the short-term, general hospitals and 48 percent of all hospitals, are voluntary, not-for-profit enterprises which account for more than 70 percent of patient admissions and nearly 80 percent of the total assets of community hospitals. Although long-term and specialized care institutions, government-controlled hospitals, and investor-owned hospitals make up a very important segment of the hospital population, emphasis in this book is on the voluntary, not-for-profit, community hospital. Yet, it should be understood that most of the discussion is relevant to all hospitals because, regardless of type of ownership, hospitals have many common problems with largely the same accounting and financial management solutions.

Definition and Formation

The legal concept of a corporation is that of an artificial person or legal entity created by or under the authority of an act of the legislature to accomplish some purpose which is authorized by the charter or governing statute. A corporation has identity as a legal person with many attributes of an individual; it can buy and sell, it can own real estate, and it can sue and be sued. Because the corporation is a legal entity separate and distinct from its governing board and employees, liability for acts of the corporation rests with the corporate entity and generally does not become the personal obligation of its governing board or management. The widening scope of liability that is being visited upon hospitals by the courts, however, should be recognized by those who are charged with responsibility for wise and prudent direction and control over hospital corporate affairs.

The hospital corporation comes into existence in several ways depending on the laws of the particular state of incorporation. In most states, corporations are formed by act of the legislative body or by administrative action in the office of the secretary of state. A corporate charter is obtained in which the powers to act and conduct business as a corporation are given to the hospital as set forth in its articles of incorporation. These powers are not to be confused with the hospital corporation's bylaws. Bylaws are the rules and regulations adopted by the incorporators or directors to regulate the hospital's internal affairs. The bylaws define the rights, powers, and duties of the hospital's governing board and its administrative officers within the general framework of the corporate charter.

Purpose and Objective

The hospital corporation is somewhat unique in that the purpose of its corporate existence may be described as that of rendering service to persons who are in need of medical attention and hospital care. This is the primary objective of all hospitals, including investor-owned hospital enterprises. The operations of hospitals of all types are directed to the saving of lives, the healing of the sick, and the alleviation of suffering. The investor-owned hospital corporation issues capital stock, seeks a satisfactory return on the stockholders' investment, and distributes profits to the investors. The voluntary not-for-profit hospital corporation, however, does not issue capital stock because, in the absence of profit sharing, there would be no severable value represented by capital stock certificates. Nevertheless, it should not be assumed that "not-for-profit" means that voluntary community hospitals cannot or should not earn a profit. It simply means that no part of the profits earned by such hospitals can inure to the benefit of any private individual. As explained at a later point, there are good reasons why voluntary not-for-profit hospitals should and must have a reasonable profit objective if they are to survive and meet their social objectives.

Tax Status

While the voluntary not-for-profit hospital generally is subject to payroll and certain other taxes, it is an "exempt" organization for purposes of the federal income tax on corporations. The exemption is provided in Section 501(c)3 of the Internal Revenue Code as follows:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

To qualify for this exemption, the hospital must be organized as a charitable, not-for-profit corporation whose purpose is caring for the sick. It must operate for the benefit of the indigent to the extent of its financial ability. It must not restrict the use of its facilities to any particular group of physicians or surgeons.

In order to maintain its tax exemption, the hospital must not engage in any of the prohibited transactions described in Section 503 of the Internal Revenue Code:

1. Lending money without adequate security or interest.
2. Paying compensation in excess of reasonable levels.
3. Making investments for more than adequate consideration.
4. Selling assets for less than adequate consideration.
5. Subverting in any manner substantial portions of its income or assets.

Thus, the hospital cannot engage in so-called self-dealing with disqualified persons such as board members, officers, employees, donors, and owners. Should a hospital enter into any of these transactions with such individuals, it may lose its tax exempt status. There also is an excise tax imposed on prohibited transactions.

Although the hospital may have an exemption letter from the Internal Revenue Service, it still may incur an income tax liability with respect to unrelated business income. Such income may be derived from an activity regularly carried on by the hospital but which is not substantially related to the exercise or performance of its charitable or other function constituting the basis for its exemption. Income from such activities is taxable at regular corporate income tax rates. Excluded from the definition of unrelated business income are income from hospital research activities, passive investment income in the form of interest, dividends, and rent, and gains on sales of assets.

The application of the above provisions of the federal income tax laws to a particular hospital situation is not always entirely clear. In addition, most states have registration and other requirements that must be met by not-for-profit organizations. It therefore is important that hospitals seek the advice of professional tax advisors on these matters.

Organization

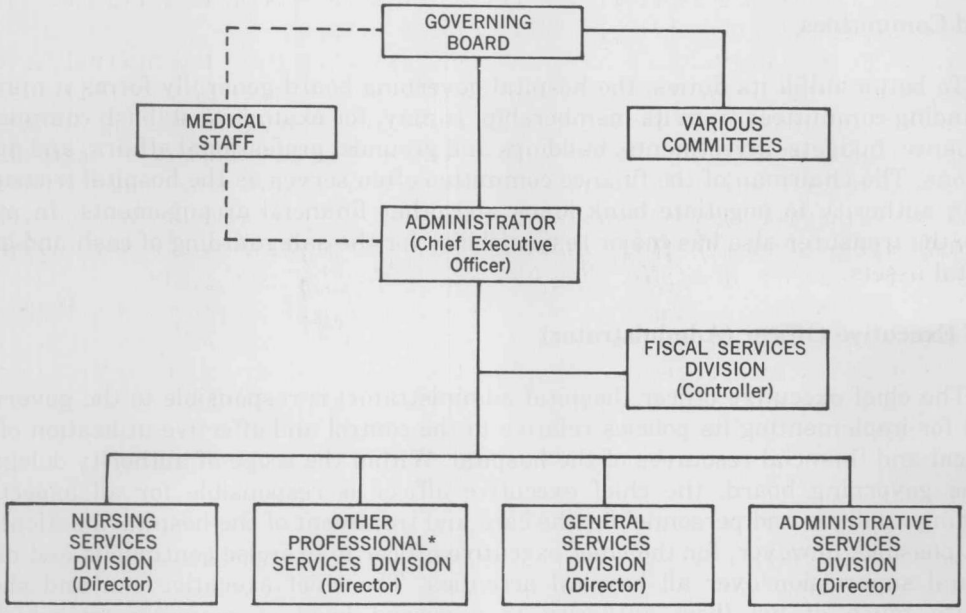
The contemporary hospital utilizes different kinds of specialized resources and makes available on a virtually continuous basis an ever-expanding spectrum of services. These services are provided by personnel employed in a diversity of occupations ranging from housekeepers to medical research scientists. While providing these services, there must be a constant concern for economy. The only way that a hospital will achieve its service and financial objectives is by effectively organizing its physical and human resources. Only by dividing the work of the hospital into manageable units where authority is centralized and responsibility is fixed can efficiency be assured. Duties must be clearly defined and interrelationships among organizational units must be carefully structured so that all individuals and groups work in a coordinated and cooperative manner toward common goals.

A sound organizational structure is an essential requirement for effective management. While certain basic principles of organization are generally applicable to all enterprises, there is no single organization plan that can be regarded as the proper plan for all hospitals. No two hospitals are alike in all respects. What may be a suitable organizational structure for one may not be applicable to another because of differences in size, range of services, type of personnel, management philosophy, and other characteristics. A typical general pattern of organization, however, is indicated in Figure 1-1. More detailed organization charts are examined in Chapters 4 and 9.

Governing Board

Ultimate authority and responsibility for the proper and prudent management of the hospital's affairs rests with its governing board. The governing board of the voluntary not-for-profit hospital has a fiduciary obligation to the community at large to preserve the assets of the hospital and to direct the hospital business in a manner that ensures the continuity of hospital services. Membership on a hospital board involves a serious

Figure 1-1.
General Organization of the Hospital



*Non-nursing.

moral and legal responsibility, and members should be chosen with great care and circumspection. In many cases the board has a broad membership drawn from various sections of the community, including different ethnic, religious, economic, and cultural groups.

The corporate laws of each state establish qualifications for membership on governing boards. The number of members usually is set within certain limits by statute. The bylaws of the hospital corporation define the duties of the board to include, through the chief executive officer or administrator, the control and use of the physical and financial resources of the hospital. The board must be active; it must direct the hospital's business in good faith and with reasonable care. Failure of the board to function has been held to constitute mismanagement, even though the board is not expected to personally manage the day-to-day operations of the hospital. This authority can and should be delegated to the chief executive officer who is held accountable to the board for compliance with the broad operating policies it establishes. The board, however, cannot rid itself of responsibility in this way.

Medical Staff

The importance of the medical staff in the hospital organization is obvious. Doctors who practice within the hospital usually are organized according to service and specialties. While the staff does not have direct authority in the management of the hospital, it does have a very significant influence on the hospital's operations, policies,

and financial success. Therefore, it is essential that a cooperative working relationship be maintained between the medical staff and the hospital's financial managers.

Board Committees

To better fulfill its duties, the hospital governing board generally forms a number of standing committees from its membership. It may, for example, establish committees for finance, budgets, investments, buildings and grounds, professional affairs, and public relations. The chairman of the finance committee often serves as the hospital treasurer, having authority to negotiate bank loans and other financial arrangements. In many cases, the treasurer also has major responsibility for the safeguarding of cash and other hospital assets.

Chief Executive Officer (Administrator)

The chief executive officer (hospital administrator) is responsible to the governing board for implementing its policies relative to the control and effective utilization of the physical and financial resources of the hospital. Within the scope of authority delegated by the governing board, the chief executive officer is responsible for all aspects of providing facilities and personnel for the care and treatment of the hospital's patients. It is not possible, however, for the chief executive officer to exercise continuous and direct personal supervision over all hospital activities. The chief executive can and should delegate much of his (her) authority to a second level of management which is accountable for the effective planning and control of the various organizational units within the hospital.

As shown in Figure 1-1, the hospital is often organized into several broad divisions, each having a director responsible for its operations. For a more detailed organization chart, see Figure 4-11. Emphasis in this book is on the role of the director of fiscal services (sometimes referred to as the hospital controller). The authority for financial management of the hospital comes from the chief executive officer to whom the fiscal services executive is directly responsible. While the director of fiscal services has authority for the day-to-day management of financial operations, the chief executive officer (using various reports and control systems) must constantly ascertain that financial management responsibilities are being carried out in an effective manner.

Director of Fiscal Services (Controller)

In years past, the hospital controller was sometimes little more than a glorified bookkeeper and officer manager. Today, however, the controller, or director of fiscal services, is or should be the most critically important person in the financial management structure. If properly qualified, this manager should be the hospital's chief financial officer and should function at the policy-making level. Governing boards and chief executive officers should clearly recognize the imperative need for, and the value of, top quality financial management that can be developed and maintained through the employment of a first-rate financial manager.

The precise title and role of the fiscal services manager varies somewhat from one hospital to another, but the functions of a well-qualified and experienced hospital financial executive may be generally defined to include the following:[1]

A. Planning

Establishment, coordination, and administration, as an integral part of management, of an adequate plan for the control of operations. Such a plan, to the extent required in the hospital, would provide:

1. Long- and short-range financial planning.
2. Budgeting for capital expenditures and operations.
3. Revenue forecasting.
4. Performance evaluation.
5. Pricing policies.
6. Economic appraisal (continuous appraisal of economic and social forces and government influences and interpretation of their effects upon the hospital).
7. Analysis of acquisitions and divestments of operating segments.

B. Provision of Capital

Establishment and execution of programs for the provision of capital required by the hospital, including negotiating the procurement of capital and maintaining the required financial arrangements.

C. Administration of Funds

1. Management of cash, investments and pension funds.
2. Maintenance of banking arrangements.
3. Receipt, custody, and disbursement of the hospital's monies and securities.
4. Credit and collection management.
5. Custodial responsibilities.

D. Accounting and Control

1. Establishment of accounting policies.
2. Development and reporting of accounting data.
3. Cost finding and analysis. Cost standards.
4. Internal auditing.
5. Accounting systems and procedures.
6. Reporting to government agencies.
7. Reporting and interpretation of results of operations to management.
8. Comparison of performance with operating plans and standards.

E. Protection of Assets

1. Provision of insurance coverage as required.
2. Assure protection of hospital assets and loss prevention through internal control and internal auditing.
3. Real estate management.

F. Tax Administration

1. Establishment and administration of tax policies and procedures.
2. Relations with taxing agencies.
3. Preparation of tax reports.
4. Tax planning.

G. Relations with External Groups

Establishment and maintenance of communications with investors, creditors, third-party payers, government agencies, hospital associations, and the general public.

H. Evaluation and Consulting

Consultation with and advice to other hospital executives on hospital policies, operations and objectives, and the effectiveness thereof.

I. Management Information Systems
Development and use of electronic data processing facilities, management information systems, and other systems and procedures.

The functions described constitute the total financial management task in hospitals. Depending upon the size of the hospital, its organizational structure, the capabilities of its management personnel, and other factors, these functions usually are divided among the chief executive officer, the director of fiscal services, and the treasurer in some logical and workable manner. A major share of financial responsibilities naturally is assigned to the director of fiscal services who, because of education and experience in accounting and finance, ordinarily is best equipped to deal with a majority of the functions described.

A simpler, more functionally oriented listing of the responsibilities of the financial executive is provided by Berman and Weeks as follows:[2]

1. Planning (budgeting) operations, for both the short and long run, in order to produce a comprehensive, coordinated approach to the achievement of the hospital's objective(s).
2. Recording and summarizing all of the financial transactions of the hospital in order to provide an accurate statement of financial condition and operating results.
3. Measuring and evaluating actual performance against meaningful standards in order to assist functional managers in controlling operations and accomplishing the operational plan.
4. Reporting the results of operations to various levels of management in order to link the planning, recording and measuring functions into an effective control process.
5. Advising the chief executive officer as to the total operational performance and the impact of external factors in order to both evaluate the current status of operations and establish policies for the future.

Thus, the hospital financial manager's role extends far beyond mere record-keeping; this executive also plans, measures and evaluates, reports, and advises. When these functions are performed well, the hospital financial manager makes an essential contribution to the achievement of hospital operational objectives.

The director of fiscal services generally requires a sizable staff in order to carry out the many important tasks and duties assigned to the fiscal services function. Figure 1-2 provides an organization chart that illustrates the manner in which the fiscal services division or controllership function may be organized in a hospital of medium size.

FINANCIAL MANAGEMENT

As noted, the basic purpose of the hospital enterprise is that of providing healthcare services of the quality and quantity required by the community it serves. The objective of hospital financial management is to plan and control the activities and