

CHAPTER 3

The Income Statement and Statement of Changes in Equity

We begin our coverage of healthcare finance topics with **financial accounting**, which involves the preparation of a business's financial statements. These statements are designed to provide pertinent financial information about an organization both to its managers and to the public at large. In this chapter, we introduce basic concepts and discuss how organizations report financial performance, specifically revenues, expenses, and profits.

Introduction to Financial Accounting

- **Financial accounting** involves identifying, recording, and communicating the operational results and status of *an organization* (as opposed to a subunit).
- Financial accounting information is conveyed by a business's **financial statements**. The four most important are:
 - Income statement
 - Statement of changes in equity
 - Balance sheet
 - Statement of cash flows

Introduction to Financial Acct. (Cont.)

- The requirement to provide financial accounting information is driven by the need of *outsiders* to have reliable information regarding the financial status of an organization.
- However, the information presented in financial statements is as important to *managers* as it is to outsiders.
 - Presents a consistent audited view of an organization's financial position.
 - Is easily compared to similar organizations.

Regulation and Standards

- The **Securities and Exchange Commission (SEC)** has the legal authority to regulate the form and content of financial statements.
- However, the SEC relies on the following organizations for implementation:
 - **Financial Accounting Standards Board (FASB)**
 - *Industry Committees* of the **American Institute of Certified Public Accountants (AICPA)**
 - *Principles and Practices Board* of the **Healthcare Financial Management Association (HFMA)**

GAAP

- The conventions that have evolved from the pronouncements and rulings of the implementing organizations constitute a set of guidelines for the preparation of financial accounting statements called **generally accepted accounting principles (GAAP)**.
- GAAP applies *only* to financial accounting statements (as opposed to statements constructed for internal use).
- ? Does GAAP remain static over time?

Conceptual Framework

- The individuals who create GAAP do not work in a vacuum, but rather follow a set of **10** basic concepts.
- The concepts, which are explained on the next three slides, are broken down into three categories:
 - Assumptions (4)
 - Principles (4)
 - Constraints (2)

Assumptions

- ***Accounting entity.*** The specific entity for which the statements apply can be defined.
- ***Going concern.*** It is assumed that the entity will have an indefinite lifetime rather than be liquidated in the near future.
- ***Periodicity.*** The time period applicable to the statements can be defined.
- ***Monetary unit.*** The monetary unit of measurement can be defined. In the United States, the unit is the US dollar, unadjusted for inflation or deflation.

Principles

- ***Historical costs.*** Requires most assets to be valued at acquisition (historical) costs rather than fair market (current) value.
- ***Revenue recognition.*** Revenues must be recognized in the period in which they are realizable and earned.
- ***Expense matching.*** Expenses must be matched (in time) to the related revenues.
- ***Full disclosure.*** Financial statements must contain a complete picture of the economic (financial) events of the organization.

Constraints

- **Materiality.** To keep statements manageable, only entries that are important to the operational and financial status of the organization need be separately identified.
- **Cost-Benefit.** Financial statements cannot report all possible information that every potential user might find relevant. When deciding what information should be reported and how it will be done, standard setters must determine whether the benefits outweigh the associated costs.

Cash Versus Accrual Accounting

- **Cash accounting** recognizes an event when a *cash transaction* takes place.
 - Simple and easy
 - Mimics tax statements
- **Accrual accounting** recognizes an event when a *cash obligation* is created.
 - More complicated
 - Provides a better picture of the true economic status of a business
 - Is required by GAAP
- **Modified cash accounting** is a blend of the two methods often used by small (non-GAAP) businesses.

Recording and Compiling Data

- A **transaction** is an exchange of goods (including cash) or services from one individual or business to another.
- Once a transaction is identified, it must be recorded, or **posted**, to an **account**, which identifies a *unique activity* within the business.
- Businesses use a **chart of accounts** to assign numeric identifiers to individual accounts.

Recording and Compiling Data (Cont.)

- Each transaction is posted by a **journal entry**.
- Because journal entries are always posted *twice*, the system is called a **double entry** system.
- To handle the double entries, accounts are set up in a T format, and hence they are known as **T accounts**.

Recording and Compiling Data (Cont.)

- Ultimately, the journal data are used to create financial statements:
 - Income statement
 - Statement of changes in equity
 - Balance sheet
 - Statement of cash flows
- The primary means for disseminating financial statements is the **annual report**.
 - It begins with a verbal discussion of current operating results and expectations for the future.
 - Followed by the financial statements, which include **notes** and **supplementary information**.

Income Statement Basics

- Perhaps the most important question about a business's *financial status* is whether or not it is making money.
- The **income statement** provides information about a business's operations and *economic profitability*.
- The income statement is often called by other names:
 - Statement of operations
 - Statement of activities
 - Statement of revenues and expenses

Income Statement Basics (Cont.)

- The income statement reports the results of operations *over some period of time*, say, a year. It has three key elements:
 - **Revenues**, which under accrual accounting represent both cash received and payer obligations.
 - **Expenses**, which are the *resource expenditures* required to produce the revenues. Again, note that under accrual accounting both cash and noncash expenses are recognized.
 - **Profit** = Revenues – Expenses.
 - Operating profit (Operating income)
 - Net profit (Net income)

Revenues

- **Revenues** are shown in several different formats depending on the type of provider. Sunnyvale reports several categories of **operating revenue**.
- **Patient service revenue**
 - Represents the amount based on **payer contracts** as opposed to **chargemaster** prices.
 - Includes only fee-for-service (FFS) revenue.
- **Net patient service revenue** reports the amount expected to be collected (after the **provision for bad debts** is deducted).

Revenues (Cont.)

- **Premium revenue** reports revenues from **capitated** patients (as opposed to FFS patients).
- **Other revenue** represents revenues from patient services–related sources, including such items as office rentals, parking fees, and cafeteria sales.
- **Net operating revenues** reports the total amount of revenues related to patient services.
- In reporting revenues, note the following:
 - **Discounts and allowances** are not reported.
 - **Charity care** is not reported.

Revenues (Cont.)

- Note that, because of accrual accounting, the net operating revenues reported do **not** represent the actual amount of cash collected in each year:
 - Some portion has not yet been collected. The **uncollected portion** will appear on the balance sheet in an account titled **net patient accounts receivable**.
 - In addition, some revenues reported in the previous year were collected this year.

Revenues

	2015	2014
Operating Revenues:		
Patient service revenue	\$ 150,118	\$123,565
Less: Provision for bad debts	<u>2,000</u>	<u>1,800</u>
Net patient service revenue	\$ 148,118	\$ 121,765
Premium revenue	18,782	16,455
Other revenue	<u>3,079</u>	<u>2,704</u>
Net operating revenues	<u>\$ 169,979</u>	<u>\$140,924</u>

Expenses

	2015	2014
Expenses:		
Salaries and benefits	\$ 126,223	\$ 102,334
Supplies	20,568	18,673
Insurance	4,518	3,710
Lease	3,189	2,603
Depreciation	6,405	5,798
Interest	<u>5,329</u>	<u>3,476</u>
Total expenses	<u>\$ 166,232</u>	<u>\$136,594</u>

Margin

	2015	2014
Operating income	\$ 3,747	\$ 4,330
Nonoperating income:		
Contributions	\$ 243	\$ 198
Investment income	3,870	3,678
Total nonoperating income	\$ 4,113	\$ 3,876
Net income	\$ 7,860	\$ 8,206

Expenses

- **Expenses** represent the resources used to create revenues—they are the costs of doing business. Like revenues, under accrual accounting, expenses do not necessarily reflect cash outlays.
- Expenses may be categorized by:
 - **Natural classification**, such as salaries, supplies, research, and so on.
 - **Functional classification**, such as inpatient services, outpatient services, and so on.

Expenses (Cont.)

- **Salaries and benefits expense** represents labor costs.
 - Typically, this is the largest expense category for health services organizations.
 - Although only summary information is given on the income statement, details are available internally from the managerial accounting system.
- **Supplies expense** represents the cost of expendable (primarily medical) materials.
 - The dollar amount shown represents the *amount consumed*, not the amount purchased.
 - Supply stocks are reported on the balance sheet.

Expenses (Cont.)

- **Insurance expense** represents the cost of commercial insurance purchased to protect the clinic against several risks, including **property risks** and **liability risks**.
- Sunnyvale owns most of its land and buildings, but it leases much of its diagnostic equipment. **Lease expense** reports the cost of its leases.

Expenses (Cont.)

- **Depreciation expense** arises because of the **expense matching principle**—expenses must be matched to the revenues with which they are associated.
- While **operating costs** such as labor and supplies are assumed to produce current revenues and hence are immediately reported (**expensed**) on the income statement, the costs of long-lived assets (buildings and equipment) are **not** reported on the income statement at the time the acquisition is made.

Depreciation Example

Expenses (Cont.)

- Rather, the “cost” of a long-lived asset is first *capitalized* (recorded on the balance sheet as an asset of the business). Then, this amount is *amortized* (or spread) over the accounting life of the asset, which means the cost is shown (expensed) on the income statement in increments over time.
- The amortization expense of buildings and equipment when listed on the income statement is called *depreciation*.
- For *financial accounting purposes*, depreciation is calculated by the **straight-line method**.

Expenses (Cont.)

- Most expense items listed on the income statement only *approximate* actual cash expenditures. The relationship is not exact because of accrual accounting.
- However, depreciation has *no associated cash expenditure*. Such an expense is referred to as a **noncash expense**.
- **Interest expense** reports the amount of interest *paid* (or *obligated*) on debt financing.

Expenses (Cont.)

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- **Interest expense** reports the amount of interest *paid* (or *obligated*) on debt financing.

Operating Income

- Although the reporting of revenue and expenses is important, profitability is the single *most important* element of the income statement.
- For *healthcare providers*, the income statement often reports two profitability measures. **Operating income** measures *economic profitability* as defined by GAAP with a focus on *patient service activities*.
- It is an important measure of profitability because patient services represent the organization's core business.

Nonoperating Income

- **Nonoperating income** reports income from activities not related to the provision of patient services.
- **Contributions** report donations that can be *immediately spent*. (Contributions that create *endowments* are not reported on the income statement.)
- **Investment income** lists income from (1) excess cash held as reserves or to meet known future needs and (2) endowments.

Net Income

- The second measure of profitability, which is often referred to as the “*bottom line*,” is **net income**.
- Net income measures **overall (total) economic profitability** as defined by GAAP.
- In *not-for-profit businesses*, net income typically is called:
 - Revenues over expenses
 - Excess of revenues over expenses
 - Change in net assets

Net Income (Cont.)

- The income statements of many *not-for-profit corporations* contain a section below the net income line that reconciles net income with the balance sheet **net assets (equity) account**. (Sunnyvale uses a separate statement, discussed shortly.)
- Note that *economic profitability* is a complex concept that is very difficult to measure, because economic gains and losses often are *not* matched by easily identifiable and measurable events.
- ? What does this complexity mean for users of financial statement information?

Net Income (Cont.)

- In a *not-for-profit corporation*, the entire amount of net income is reinvested in the business.
- In a *for-profit business*, net income, which constitutes the residual earnings of the business, belongs to the owners.
 - Some portion of net income may be returned to owners as dividends (or bonuses).
 - The remainder is reinvested in the business.

Net Income Versus Cash Flow

- Because of *accrual accounting*, net income does not represent **cash flow**.
 - Some income statement items represent cash flows; others do not.
 - Some, such as revenues, represent partial cash flows.
- With only income statement data, cash flow (CF) can be *approximated* by:
CF = Net income + Noncash expenses
= Net income + Depreciation
= \$7,860,000 + \$6,405,000 = **\$14,265,000**

Income Statements of Investor-Owned Businesses

- The income statements of *investor-owned* and *not-for-profit* businesses are very similar.
 - The revenues and costs to organizations in the same line of business are similar, regardless of ownership.
 - However, some transactions, such as income tax payments, clearly are applicable only to for-profit businesses.
- Line-of-business differences have a greater impact on financial statements than do ownership differences.

Impact of Depreciation Expense on Cash Flow

Statement of Changes in Equity

- The **statement of changes in equity** reconciles the income statement net income item with the balance sheet equity account.
- For a *not-for-profit organization*, the entire amount of net income flows to the balance sheet. Also, this statement often is affixed to the bottom of the income statement rather than presented separately.
- In a *for-profit business*, there are typically deductions to net income (often dividends) that reduce the amount that flows to the balance sheet.

Statement of Changes in Equity

Alternate Tax Scenarios – Depreciation

	<i>Not-for-Profit</i> <i>(Tax rate = 0%)</i>	<i>For-Profit A</i> <i>(Tax rate = 20%)</i>	<i>For-Profit B</i> <i>(Tax rate = 40%)</i>	<i>For-Profit C</i> <i>(Tax rate = 40%)</i>
Total revenues	<u>\$174,092</u>	<u>\$174,092</u>	<u>\$174,092</u>	<u>\$174,092</u>
Expenses:				
All except depreciation	\$159,827	\$159,827	\$159,827	\$159,827
Depreciation	<u>6,405</u>	<u>6,405</u>	<u>6,405</u>	<u>0</u>
Total expenses	<u>\$166,232</u>	<u>\$166,232</u>	<u>\$166,232</u>	<u>\$159,827</u>
Taxable income	<u>\$ 7,860</u>	<u>\$ 7,860</u>	<u>\$ 7,860</u>	<u>\$ 14,265</u>
Taxes	<u>0</u>	<u>1,572</u>	<u>3,144</u>	<u>5,706</u>
Net income	<u>\$ 7,860</u>	<u>\$ 6,288</u>	<u>\$ 4,716</u>	<u>\$ 8,559</u>
Cash flow (NI + depreciation)	<u>\$ 14,265</u>	<u>\$ 12,693</u>	<u>\$ 11,121</u>	<u>\$ 8,559</u>

An Introduction to Financial Condition Analysis

- In **financial condition analysis**, values from the financial statements are combined to form *ratios* that have easily interpretable economic meaning.
- For example, **total (profit) margin**:

$$\begin{aligned}\text{Total margin} &= \frac{\text{Net income}}{\text{Total revenue}} \\ &= \frac{\$7,860}{\$174,092} = 0.045 = 4.5\%.\end{aligned}$$

We will tackle more of FCA in Chapter 17

Conclusion

- This concludes our discussion of *Chapter 3* (The Income Statement and Statement of Changes in Equity).
- Although not all concepts were discussed in class, you are responsible for all of the material in the text.
- ? Do you have any questions?