This is a sample of the instructor resources for *Healthcare Finance: An Introduction to Accounting and Financial Management* by Louis Gapenski. This sample contains the instructor notes and PowerPoint slides for Chapter 3.

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**ANSWERS TO END-OF-CHAPTER QUESTIONS**

3.1  

**a. Stakeholders** are the parties who have a financial interest in a business. In a not-for-profit business, such as a community hospital, stakeholders include managers, staff physicians, employees, suppliers, creditors, patients, and even the community at large. Investor-owned businesses have essentially the same set of stakeholders, with the addition of owners (in corporations, stockholders).

**b.** Because all stakeholders, by definition, have at least some financial interest in the business, all stakeholders have an interest in its financial condition. However, of all the outside stakeholders, investors typically have the greatest financial interest in healthcare organizations, and hence are the parties most interested in the business’s financial condition. In addition to investors, the business’s managers, including its board of directors (trustees), also are vitally concerned about financial condition. After all, managers are charged with ensuring that the organization has the financial strength to accomplish its mission, whether that mission is to maximize the wealth of its shareholders or to provide healthcare services to the community at large.

3.2  

**a. Generally accepted accounting principles (GAAP)** can be thought of as a set of guidelines (objectives, conventions, and principles) that have evolved through the years to guide the preparation and presentation of financial statements.

**b.** The GAAP were designed to provide the information needed by stockholders, creditors, and other interested parties to make the best-informed decisions, primarily investment decisions.

**c.** Several organizations are involved in establishing the GAAP. The Securities and Exchange Commission (SEC), an independent regulatory agency of the U.S. government, has the overall authority to establish and enforce the form and content of financial statements. However, the SEC does not create the standards, but rather allows other organizations to create and implement the standard system. For the most part, the SEC has delegated the responsibility for establishing standards to the Financial Accounting Standards Board (FASB), a private organization whose mission is to establish and improve standards of financial accounting and reporting for private businesses. (The Government Accounting Standards Board [GASB] has the identical responsibility for public businesses.) The FASB and its predecessor organization (the Accounting Principles Board) promulgate guidelines in pronouncements with various names such as statements or opinions. Typically, the guidelines established by the FASB apply across a wide range of industries and, by design, are somewhat general in nature. Yet another organization is needed to provide more specific implementation rules, especially when industry-unique guidance is required. This task is accomplished by the American Institute of Certified Public Accountants (AICPA), which is the professional association of public (financial) accountants. The AICPA has substantial influence with its membership, much like the influence that the American Medical Association (AMA) has on its member physicians. The AICPA, through its industry committees, promulgates the actual rules that accountants follow when preparing and auditing an organization’s financial statements. For example, financial statements in the healthcare industry are based on the AICPA Audit and Accounting Guide titled *Health Care Organizations.* Finally, when even more specific guidance is required, other professional organizations may participate in the standard-setting process, although such work does not have the same degree of influence as the FASB or the AICPA. For example, the Healthcare Financial Management
Association (HFMA) has established the *Principles and Practices Board*, which develops position statements on issues requiring further guidance.

3.3 a. The first step in the preparation of financial statements is to define the *accounting entity*. This step is important for two reasons. First, for investor-owned businesses, financial accounting data must be pertinent to the business activity, as opposed to the personal affairs of the owners. Second, within any business, the accounting entity defines the specific areas of the business to be included in the statements. In effect, the accounting-entity specification establishes boundaries that tell accountants what data must be included as well as inform readers what business (or businesses) is being reported.

b. It is assumed that the accounting entity will operate as a *going concern* and will have an indefinite life. This means that most assets should be valued on the basis of their value to the ongoing business, as opposed to their current market (liquidation) value. Furthermore, short-term events should not be allowed to unduly influence the data presented in financial statements. The going concern assumption, coupled with the fact that financial statements must be prepared for relatively short periods (as explained next), means that financial accounting data are not exact but represent logical and systematic approaches applied to complex measurement problems.

c. Because it is assumed that accounting entities have an indefinite life, but users of financial statements require the information that they convey on a frequent basis, it is common to report financial results on a regular basis. The period covered by such statements, which is called an *accounting period*, can be any length of time over which an organization’s managers, or outside parties, want to evaluate operational results. Most health services organizations use calendar periods—months, quarters, and years—as their accounting periods.

d. The conversion of economic events to financial accounting data is not an easy task. One of the cornerstones of measurement is *objectivity*; that is, the information reported in financial statements must, to the extent possible, be based on objective, verifiable supporting data. Thus, rather than pull data "out of the air," financial statement preparers should base their data on event documentation such as invoices and contracts. In addition, financial accounting information should be *reliable*, which means that users can depend on it to be reasonably free of error and bias and hence can assume that the information fairly represents the economic events being portrayed. In general, *reliability* is ensured when independent measurers (auditors), following identical guidelines, reach the same conclusions regarding the values in the financial statements as do the in-house preparers.

e. The *monetary unit* provides the common basis by which economic events are measured. In the United States, this unit is the dollar. Thus, all transactions and events must be expressed in dollar terms.

f. Financial statements must be *relevant* to their users, which means that the information must make a difference in decisions that are being made. Thus, financial statements must include sufficient information upon which to base decisions but not so much information that decision making becomes bogged down by nonessential detail.

g. Financial statements must contain a complete picture (*full disclosure*) of the economic events of the business. Anything less would be misleading by omission. Furthermore, because financial statements must be relevant to a diversity of users, full disclosure, like relevance, pushes financial accountants to include more, rather than less, information in financial statements.
h. If financial statements were created that contained all possible information, they would be so long and detailed that making inferences about the organization’s economic status would be very difficult without a great deal of analysis. Thus, to keep the statements manageable, only entries that are material to the financial condition of an organization need to be separately categorized. In general, the materiality principle affects the presentation of the financial statements rather than their aggregate financial content (i.e., the final numbers). Clearly, leeway exists for interpretation as to what is and is not material, so some differences are likely to occur in financial statements between similar organizations.

i. Although financial accountants try their best to paint a fair picture of a business’s financial status, if uncertainty in the data or GAAP permit alternative interpretations, the conservatism concept says to choose the approach that is least likely to overstate the business’s financial condition. This does not mean that financial statements should deliberately underestimate a business’s position but, when in doubt, choose the path that will least likely overstate the position.

j. Consistency involves the application of like guidelines to a single accounting entity over time. When a business’s financial statements are compared over extended periods—say, annual statements for the past ten years—users must feel confident that they are comparing “apples to apples” and not “apples to oranges.” Consistency does not mean that a business, when there is a choice, must stick with the convention chosen forever. However, any change that would create inconsistent statements must be disclosed along with the impact of that change. Comparability is similar to consistency, except that the concept applies across businesses and to different accounting periods. When users look at quarterly and annual financial statements of the same business, they must feel confident that the data are comparable. Furthermore, when the statements of one business are compared with the statements of another, but similar, business—say, two hospitals—the data must be comparable.

3.4 Under accrual accounting, both revenues and expenses are recorded when the obligation to make payment occurs. This logic depends on the revenue recognition principle, which states that revenue is recognized when it is realizable and earned. Thus, revenue is recognized when a service is rendered that creates a measurable payment obligation on the part of the purchaser, rather than when the payment is actually received. Expenses are treated in the same way: they are recorded when the obligation is created. In addition, under accrual accounting, expenses must follow the matching principle, which requires that an organization’s expenses be matched, to the extent possible, with the revenues to which they are related. In essence, after the revenues have been allocated to a particular accounting period, all expenses associated with producing those revenues should be matched to the same period.

Under cash accounting, as its name implies, revenues and expenses are recorded when the cash transaction occurs. Supporters of accrual accounting argue that the cash basis of accounting fails to portray the true economic status of the organization—the primary goal of financial accounting—because it is the provision of the service that actually creates the revenue. In rebuttal, the supporters of cash accounting argue that accrual accounting is misleading, because readers of financial statements logically expect revenues to represent cash inflows to the reporting organization.
3.5 The *income statement* summarizes the operations (i.e., the activities) of an organization with a focus on its revenues, expenses, and profitability. Thus, the income statement is often called the *statement of operations* or the *statement of activities*. Revenues are the starting point of an income statement, then expenses are subtracted to determine an organization’s net income, or accounting profitability.

3.6 a. *Gross revenues* are revenues based on a provider’s schedule of charges, while *net revenues* are the revenues that are actually anticipated. To obtain the amount of net revenues, revenues lost to payer discounts and to charity care patients are subtracted from gross revenues.

b. *Patient service revenue* stems directly from the provision of patient services, as opposed to revenues stemming from other activities. However, patient service can be rather broadly defined, so revenues associated with such activities as parking garages and visitor food services generally are categorized as patient service revenue. *Other revenue* is nonpatient related, such as interest earned on securities investments. Additional sources of other revenue include revenue from such activities as consulting services, renting of space, educational activities, and sales of pharmaceuticals to employees, staff, and visitors.

c. *Charity care* represents services that are provided to patients who do not have the capacity to pay. *Bad debt losses* result from the failure to collect for services provided to patients or third-party payers that do have the capacity to pay. Charity care is not reported directly on the income statement because net, rather than gross, revenues are reported. However, charity care is typically reported in a footnote. Conversely, bad debt losses are reported as an operating expense directly on the income statement.

3.7 a. *An expense*, which represents the cost of doing business, is a deduction from revenues. Expenses may be reported using either a *natural classification*, which classifies expenses by the nature of the expense, such as salaries or supplies, or a *functional classification*, which classifies expenses by purpose, such as inpatient services or outpatient services. Note that under accrual accounting, expenses reported on the income statement do not precisely match the cash outflows of the business.

b. To match the cost of fixed assets to the services supported by those assets, accountants use the concept of *depreciation*, which spreads the cost of a fixed asset over many years. In essence, depreciation expense recognizes that fixed assets, which are not free, are required to provide the services that generate revenues. However, because fixed assets often can be used for long periods, and hence generate revenues over many years, the costs associated with such assets, which should be matched to the revenues, must also be spread over long periods. The calculation of depreciation expense is somewhat arbitrary, so its amount generally is neither closely related to the actual usage (wear and tear) of a fixed asset nor its true loss in market value.

c. Other categories of expenses include operating expenses such as salaries and benefits, amortization expense, medical supplies, and lease expense, as well as nonoperating expenses such as interest expense.

3.8 a. *Net income* is the residual earnings of the business, defined as revenues less expenses. Its purpose is to measure the *economic profitability* of the business.
b. Net income is often called the “bottom line” because it is the primary focus of the income statement. In essence, the entire rationale for estimating a business’s revenues and expenses is to determine its profitability, which net income provides.

c. Because the revenues and expenses listed on the income statement follow accrual accounting concepts, net income measures accounting or economic profitability rather than the actual movement of cash. Cash flow, on the other hand, represents the actual cash that a business generates over some period. As a first approximation, cash flow can be estimated by adding noncash expenses to net income.

d. One could argue that, over the long run, financial condition is more closely related to net income, because net income attempts to measure economic (long-term) profitability. There is no doubt, however, that current and near-term financial condition is more closely related to cash flow.

ANSWERS TO END-OF-CHAPTER PROBLEMS

3.1 Here is one version of a correctly ordered income statement. Note, however, that some of the items can be ordered differently as long as the general format below is followed.

Revenues:
Patient service revenue $440,000
Other revenue 10,000
Interest income 40,000
Total revenues $490,000

Expenses:
Salaries and benefits $150,000
Purchased clinical services 90,000
General/administrative expenses 70,000
Depreciation expense 90,000
Bad debt expense 40,000
Interest expense 20,000
Total expenses $460,000

Net income $30,000

3.2 a. The primary difference is in the listing of revenues. Being an HMO, revenues are listed as premiums earned and coinsurance rather than as net patient service revenue. Otherwise, the expense categories are roughly the same.

b. BestCare did not spend $367,000 on new fixed assets during 2007. The depreciation expense entry recognizes the loss of value, or “wear and tear,” that the HMO’s fixed assets presumably experienced during the year. Note, however, that depreciation expense is calculated according to somewhat arbitrary rules, so the amount listed may not reflect the actual change in market value of those assets.
c. The HMO gets its revenues from employers and individuals. On the basis of contracts in force, the amount of revenues due for coverage in 2007 was $440,000. However, BestCare expects that not all of these revenues will be collected. The estimated amount of uncollectible revenues, $19,000, is listed as an expense item called provision for bad debts.

d. Total profit margin is defined as net income divided by total revenues. Thus, BestCare's total profit margin for 2007 was $1,218 / $28,613 = 0.043 = 4.3%. This means that each dollar of revenue produced 4.3 cents of earnings for the HMO. The higher the total profit margin, the better the organization's expense control, because the greater the amount of revenues that flows through to net income.

3.3 a. The primary difference here is that lines are added that contain the operating (taxable) income and provision for income taxes entries. These lines indicate that Green Valley is an investor-owned, and hence taxable, nursing home. Note that Green Valley's implied tax rate is $31,167 / $89,048 = 0.350 = 35.0%.

b. As stated in the response to Part a, Green Valley is an investor-owned (for-profit) entity.

c. Green Valley's total profit margin was $57,881 / $3,269,404 = 0.018 = 1.8%. This is significantly lower than the 2007 total profit margins of Sunnyvale (4.5 percent) and BestCare (4.3 percent). Of course, profitability depends on the line of business, the local operating environment, and how well a specific organization is managed. All things the same, however, investor-owned businesses, because of taxes, would be expected to have lower total profit margins than not-for-profit businesses.

d. Green Valley's before-tax profit margin was $89,048 / $3,269,404 = 0.027 = 2.7%, which is higher than its total profit margin. Because the before-tax margin removes the influence of taxes, it is a better measure of expense control when comparing investor-owned and not-for-profit businesses.

3.4 a. With a net income of $2.4 million on total revenues of $30 million, total expenses must be $30 – $2.4 = $27.6 million.

b. With $1 million in noncash expenses (depreciation), cash expenses must total $26.6 million.

c. Using only income statement data, cash flow can be approximated as Net income + Noncash expenses = Net income + Depreciation. For Great Forks, Cash flow = $2.4 + $1.0 = $3.4 million.

3.5 a. Here is Brandywine's 2007 income statement (in millions):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues</td>
<td>$12.0</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>All but depreciation (75%)</td>
<td>$ 9.0</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>1.5</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$10.5</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 1.5</td>
</tr>
</tbody>
</table>
b. Net income = $12.0 – $9.0 – $1.5 = $1.5 million.
   Total profit margin = Net income / Total revenues = $1.5 / $12.0 = 0.125 = 12.5%.
   Cash flow = Net income + Depreciation expense = $1.5 + $1.5 = $3.0 million.

c. Net income = $12.0 – $9.0 – $3.0 = $0.
   Total profit margin = $0 / $12.0 = 0%.
   Cash flow = $0 + $3.0 = $3.0 million.

d. Net income = $12.0 – $9.0 – $0.75 = $2.25 million.
   Total profit margin = $2.25 / $12.0 = 0.188 = 18.8%.
   Cash flow = $2.25 + $0.75 = $3.0 million.

The key point here is that depreciation, as a noncash expense, affects accounting profitability (net income), but it does not affect cash flow in not-for-profit businesses.

3.6 a. Here is Mainline’s 2007 income statement (in millions):

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues</td>
<td>$12.0</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>All but depreciation</td>
<td>$ 9.0</td>
</tr>
<tr>
<td>(75%)</td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>1.5</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$10.5</td>
</tr>
<tr>
<td>Operating income</td>
<td>$ 1.5</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>0.6</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 0.9</td>
</tr>
</tbody>
</table>

b. Net income = ($12.0 – $9.0 – $1.5) – ($12.0 – $9.0 – $1.5) x 0.4
   = $1.5 – $0.6 = $0.9 million.
   Total profit margin = Net income / Total revenues = $0.9 / $12.0 = 0.075 = 7.5%.
   Cash flow = Net income + Depreciation expense = $0.9 + $1.5 = $2.4 million.

c. Net income = ($12.0 – $9.0 – $3.0) – ($12.0 – $9.0 – $3.0) x 0.4
   = $0.0 – $0.0 = $0.
   Total profit margin = $0 / $12.0 = 0%.
   Cash flow = $0 + $3.0 = $3.0 million.

d. Net income = ($12.0 – $9.0 – $0.75) – ($12.0 – $9.0 – $0.75) x 0.4
   = $2.25 – $0.9 = $1.35 million.
   Total profit margin = $1.35 / $12.0 = 0.112 = 11.2%.
   Cash flow = $1.35 + $0.75 = $2.1 million.

With taxes introduced, the situation changes. Now, the greater the depreciation, the lower the reported profitability but the greater the cash flow. Because depreciation expense reduces taxable income but not cash flow, higher depreciation means that less money goes for taxes, and hence more is left for the business.
CHAPTER 3
Financial Accounting Basics and the Income Statement

- Introduction to financial accounting
- The standard setting process
- The income statement
  - Revenues
  - Expenses
  - Net income
- Net income versus cash flow
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 three most important are:

- Income statement
- Balance sheet
- Statement of cash flows
The requirement to provide financial accounting information is driven by the need for *outside investors* 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 investors.

Should the preparation and presentation of financial accounting data be regulated?
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)
The conventions that have evolved from the pronouncements and rulings of the implementing organizations constitute a widely accepted set of guidelines for the preparation of financial statements called generally accepted accounting principles (GAAP).

The GAAP applies *only* to financial accounting statements.

Does the GAAP remain static over time?
The following basic concepts provide the overall basis for the preparation of financial accounting information.

- Accounting entity
- Going concern
- Accounting period
- Objectivity and reliability
- Monetary unit
Measuring and Recording (Cont.)

- Relevance
- Full disclosure
- Materiality
- Conservatism
- Consistency and comparability
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 an *obligation* is created.
  - More complicated
  - Provides a better picture of the true economic status of a business
  - Is required by GAAP
Revenue Recognition Principle

Accrual accounting follows two underlying principles:

- Revenue recognition
- Matching

The revenue recognition principle specifies that revenues are recognized (recorded) when they are:

- Earned
- Realizable (known)
Matching Principle

The matching principle specifies that:

- **Revenues** must be matched with the accounting period in which they are earned.

- **Expenses** must be matched with the revenues to which they are related.

How do the revenue recognition and matching principles apply to revenues and costs under:

- Fee-for-service?
- Capitation?
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.
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 financial accounting data are used to create financial statements:
  - Income statement
  - 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 footnotes.
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
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.

- **Net income (profit)** = Revenues - Expenses.
## Sunnyvale Clinic: Revenues

*(in thousands)*

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net patient service revenue</td>
<td>$169,013</td>
<td>$140,896</td>
</tr>
<tr>
<td>Other revenue</td>
<td>7,079</td>
<td>5,704</td>
</tr>
<tr>
<td>Total revenues</td>
<td><strong>$176,092</strong></td>
<td><strong>$146,600</strong></td>
</tr>
</tbody>
</table>
Revenues are shown in several different formats depending on the type of provider. Sunnyvale has two revenue categories.

- **Net patient service revenue.** The key definitions here are:
  - Net (as opposed to *gross*)
  - Patient service revenue (as opposed to *other*)

- Note that revenue from capitated patients typically is called *premium revenue.*
Revenues (Cont.)

- In reporting revenues, note how the following categories are handled:
  - Discounts (not reported as revenue)
  - Charity care (not reported as revenue)
  - Bad debt losses (reported, but expensed later)

- Other revenue represents revenues from sources besides patient care, including:
  - Interest earned on investments
  - Contributions
  - Rental income
Revenues (Cont.)

- Note that the revenue reported does *not* represent the amount of cash collected:
  - Some portion has not yet been collected. The *uncollected portion* will appear on the balance sheet in an account titled *receivables*.
  - In addition, some revenues reported in the previous year were collected this year.

*What impact does capitation have on the amount of receivables?*

*What is the difference between *gross* and *net* patient service revenue?*
Some years ago, patient service revenue was reported using this format:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross patient service revenue*</td>
<td>$212,302</td>
<td>$177,318</td>
</tr>
<tr>
<td>Less: Contractual allowances</td>
<td>37,550</td>
<td>31,369</td>
</tr>
<tr>
<td>Indigent care</td>
<td>5,739</td>
<td>5,053</td>
</tr>
<tr>
<td>Net patient service revenue</td>
<td>$169,013</td>
<td>$140,896</td>
</tr>
</tbody>
</table>

*Based on charges

? Is the old way or the new way better?
### Sunnyvale Clinic: Expenses

(in thousands)

<table>
<thead>
<tr>
<th>Expenses:</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and benefits</td>
<td>$126,223</td>
<td>$102,334</td>
</tr>
<tr>
<td>Supplies</td>
<td>20,568</td>
<td>18,673</td>
</tr>
<tr>
<td>Insurance</td>
<td>4,518</td>
<td>3,710</td>
</tr>
<tr>
<td>Lease</td>
<td>3,189</td>
<td>2,603</td>
</tr>
<tr>
<td>Depreciation</td>
<td>6,405</td>
<td>5,798</td>
</tr>
<tr>
<td>Provision for bad debts</td>
<td>2,000</td>
<td>1,800</td>
</tr>
<tr>
<td>Interest</td>
<td>5,329</td>
<td>3,476</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>$168,232</strong></td>
<td><strong>$138,394</strong></td>
</tr>
</tbody>
</table>
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.

Which classification system is better?
Which system does Sunnyvale use?
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 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.
Insurance expense represents the cost of commercial insurance purchased to protect the clinic against several risks, including:

- **Property risks**
  - Fire
  - Weather

- **Liability risks**
  - Managerial malfeasance
  - Medical liability
Expenses (Cont.)

- Sunnyvale owns most of its land and buildings, but it leases much of its diagnostic equipment. **Lease expense** reports the cost of its leases.
  - On the balance sheet, some leased assets are reported *directly (on the face)* while others appear only in the *footnotes*.
  - Regardless of balance sheet treatment, all lease expense is reported on the income statement.

**Why do organizations use leases?**
Depreciation expense arises because of the 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 immediate revenues and hence are more or less 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.
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 as small 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*. 
Most expense items listed on the income statement only *approximate* actual cash expenditures. The relationship is not exact because of accrual accounting.

However, depreciation (and amortization) are expenses that typically have *no associated cash expenditure* during the accounting period.

Such an expense is referred to as a *noncash expense*. 
Expenses (Cont.)

- **Provision for bad debts expense** reports the amount of net patient service revenue that is not *expected* to be collected.
  - It is an estimate based on past experience.
  - Past estimates are reconciled when the data are known.

- **Interest expense** reports the amount of interest *paid* (or *obligated*) on debt financing.
## Sunnyvale Clinic: Net Income

*(in thousands)*

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenues</td>
<td>$176,092</td>
<td>$146,600</td>
</tr>
<tr>
<td><strong>Expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total expenses</td>
<td>$168,232</td>
<td>$138,394</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$  7,860</td>
<td>$  8,206</td>
</tr>
</tbody>
</table>
Although the reporting of revenue and expenses is important, the most important single line on the income statement is the "bottom line," which is net income.

Net income measures 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
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.
- The remainder is reinvested in the business.
The income statements of some not-for-profit corporations contain a section below the net income line that reconciles net income with the balance sheet net assets (equity) account.

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?
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:

\[
CF = \text{Net income} + \text{Noncash expenses} \\
= \text{Net income} + \text{Depreciation} \\
= $7,860,000 + $6,405,000 = $14,265,000.
\]
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 are greater than ownership differences.
In financial statement analysis, values may be combined to form ratios that have easily interpretable economic meaning.

For example, total (profit) margin:

\[
\text{Total margin} = \frac{\text{Net income}}{\text{Total revenue}}
\]

\[
= \frac{7,860}{176,092} = 0.045 = 4.5\%.
\]

How is this ratio interpreted?
This concludes our discussion of *Chapter 3* (Financial Accounting Basics and the Income Statement).

Although not all concepts were discussed in class, you are responsible for all of the material in the text.

Do you have any questions?