



Introduction to Healthcare Accounting

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Presentation Objectives

- **Purpose of Presentation:**
To give participants a better understanding of healthcare accounting and the issues facing healthcare audit committees

- **These concepts will enable participants to:**
 - Understand the complexity of healthcare industry and accounting
 - Gain an understanding of the numerous areas impacting healthcare accounting
 - Explain the factors that influence gross and net revenue
 - Be aware of the top accounting issues audit committees will be facing in the coming year



Audit Committee's Responsibilities

Oversight of:

- **Organization's financial reporting process and internal control over financial reporting (ICFR)**
- **Independent auditors**
- **Organization's internal auditors**
- **Organization's compliance with legal and regulatory requirements. (Whistle-blower process)**
- **Risk management**
- **Protect assets and provide proper financial oversight**

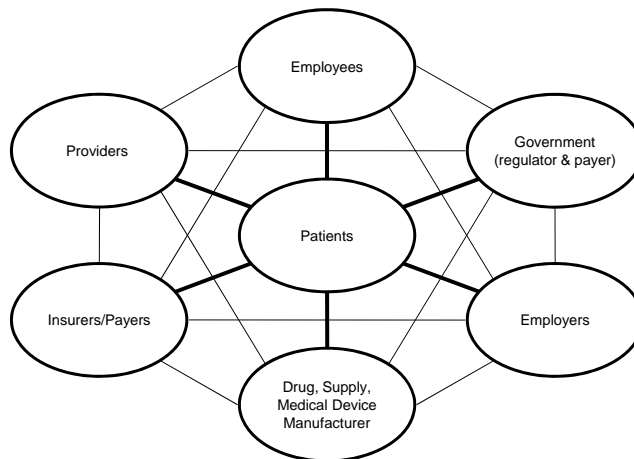


What's unique about Healthcare Accounting?

- **Gross and Net Revenue/Accounts Receivables Reserves**
- **Capital intensive business**
- **Investment valuation/tax-exempt debt**
- **Other Areas of Estimates and judgments**
 - Professional liability
 - Self Insurance liabilities
 - Third Party Settlements (govt & managed care)
 - Pension liability
 - Regulatory reserves



Healthcare Industry Players



Healthcare Balance Sheet - Assets

- **Assets are what you have (more is better)**
 - Economic resources that are expected to provide future benefits such as increasing cash inflows or reducing cash outflows
 - Current is realizable in less than a year, Long Term (LT) is greater than a year
 - Cash and investments are valued at market
 - Inventory and property are valued at historic cost, property is depreciated over life of asset
 - Pledges and receivables are discounted to present value and what we expect to collect



Healthcare Balance Sheet - Liabilities

- **Liabilities are what you owe (less is better)**
 - Economic obligations to outsiders or claims against assets
 - Payables are current, due within 1 year, and relate to obligations we have in normal course of business (accounts payable, payroll, employment taxes and benefits), PTO Liability is paid time off accrual for time off earned but not taken
 - Long term debt is paid over more than a year



Healthcare Balance Sheet – Net Assets

- **Net assets = Assets – Liabilities (more is better)**
 - Unrestricted = no restrictions
 - Temporarily restricted = donor restricted by time or use
 - Permanently restricted = donor restricted for principal, earnings used for donor intended purpose

2018

- Without donor restrictions
- With donor restrictions



Healthcare Balance Sheet Example

▪ Balance Sheet
 ▪ December 31, XXXX

▪ Current Assets			
▪ Cash	\$8,000		
▪ Short Term Investments	311,000		
▪ Patient Receivables	353,000		
▪ Other Current		<u>92,000</u>	
▪ Total Current	764,000		
▪ Marketable Securities	401,000		
▪ Other Assets	245,000		
▪ Plant Assets	<u>880,000</u>		
▪ Total Assets			\$2,290,000
▪ Liabilities			
▪ Other Current Liabilities	\$380,000		
▪ Other Long Term Liabilities	462,000		
▪ Long Term Debt	<u>646,000</u>		
▪ Total Liabilities	\$1,488,000		
▪ Net Assets			
▪ Unrestricted	696,000		
▪ Restricted	<u>106,000</u>		
▪ Total Liabilities and Net Assets			\$2,290,000

New ASU 20160-14 - 2018

▪ Net Assets		
▪ Without donor restrictions	696,000	
▪ With donor restrictions	<u>106,000</u>	



Healthcare Statement of Operations

- **Revenue - Where does it come from & how do we get more?**
 - Gross and Net revenue - Hospital inpatient, outpatient, clinic and specialty services
 - Other Operating revenue – parking ramp, joint ventures, cafeteria, etc.
 - Interest and Misc.



Healthcare Statement of Operations

- **Expenses – Where does it go & how can we spend less?**
 - Salaries & Benefits – 64%
 - Supplies and drugs –12%
 - Purchased services – 8%
 - Other -16 %



Healthcare Statement of Changes in Net Assets

- **Unrestricted contributions – recognized immediately in unrestricted fund**
- **Temporarily restricted contributions - not recognized in unrestricted fund until the restriction is released (time or use)**
- **Permanent restricted contributions - not recognized in unrestricted fund – only earnings**

2018

- **Without donor restrictions - recognized immediately**
- **With donor restrictions -- not recognized in funds without donor restriction until the restriction is released (time or use)**



Healthcare Statement of Operations Example

<ul style="list-style-type: none"> ▪ Statement of Operations ▪ Year ended December 31, XXXX 		
<ul style="list-style-type: none"> ▪ Operating Revenue 		
<ul style="list-style-type: none"> ▪ Total Net Patient Revenue 	\$2,818,000	
<ul style="list-style-type: none"> ▪ Other Operating Revenue 	<u>305,000</u>	
<ul style="list-style-type: none"> ▪ Net Operating Revenue 	\$3,123,000	
<ul style="list-style-type: none"> ▪ Operating Expenses 		
<ul style="list-style-type: none"> ▪ Salaries & Wages 	\$1,425,000	
<ul style="list-style-type: none"> ▪ Employee Benefits 	356,000	
<ul style="list-style-type: none"> ▪ Supplies 	350,000	
<ul style="list-style-type: none"> ▪ Drugs 	120,000	
<ul style="list-style-type: none"> ▪ Purchased Services 	180,000	
<ul style="list-style-type: none"> ▪ Other Expense 	347,000	
<ul style="list-style-type: none"> ▪ Depreciation 	160,000	
<ul style="list-style-type: none"> ▪ Interest 	<u>30,000</u>	
<ul style="list-style-type: none"> ▪ Total Operating Expenses 	\$ 2,968,000	
<ul style="list-style-type: none"> ▪ Income from Operations 		155,000
<ul style="list-style-type: none"> ▪ Non-Operating Revenue 		<u>45,000</u>
<ul style="list-style-type: none"> ▪ Excess of Revenues over Expenses 		\$200,000



Gross and Net Revenue

- **Health care industry nuances**
 - What healthcare charges is different from what is paid
 - Typically two parties who each pay a portion of the total payment
 - Insurer/government who pays a negotiated/legislated rate to provider
 - Patient who pays co pays, coinsurance and/or deductibles

- **Market evolution**
 - Historically minimal patient responsibility for health care services
 - Patients insulated from cost of health care
 - Confidential negotiated rates with health insurers
 - Consumer directed care
 - Results in increased patient engagement including increased patient financial responsibility
 - Patient and insurer/employer expectations driving industry transparency



Gross and Net Revenue

- **Gross Revenue**

- Aggregation of
 - What we **CHARGE**
 - What we **BILL** to third party payers or patients
- Synonyms for Charge
 - Hospital: **"Price"**
 - Clinic: **"Fee Schedule"**
- Charge transactions come from
 - **Charge master**
 - **Charge/fee schedule**

Net Revenue

Aggregation of what we collect or receive in payment from third party payers and/or patients

Net Revenue Calculation

Gross Revenue
- **CHARITY CARE**
- **UNINSURED CARE**
- **DISCOUNTS** (Payer & Gov't)
- **BAD DEBT** (uncollectible)



Gross Revenue

- **How are Charges generated?**

- Charges are the result of each individual service a patient receives that is documented in the patient medical record
 - Examples: tests, procedures, drugs, supplies, etc.
- Charges are recorded or posted to patient account in two ways
 - Automatically, when ordered in electronic medical record
 - Manually, when entered into the billing system



Gross Revenue

▪ How is the Price determined?

- Historical price level
- Market sensitivity analysis
 - Comparisons through public domain/trade association data
 - Shopped services
- Industry Benchmarks
 - Resource relationships, such as Center for Medicare & Medicaid Services (CMS) resource based relative value units (RVU's) ,etc.
- Cost basis
 - Cost only
 - Cost plus mark-up and/or flat fee for administration
- Comparison to like or existing services
- Staff input



Net Revenue – 2 components

▪ Component 1: Patient Financial Responsibility

- Self pay amount
- Patient/member responsibility/liability
 - Deductibles
 - Co-payments/Coinsurance
 - Non-covered items

▪ Component 2: Payer Financial Responsibility

- Payer Responsibility = Allowed Amount – Patient Responsibility
- Allowed Amount also referred to as
 - Reimbursement Amount
 - Contracted or Negotiated Rate or just “Rate”



Net Revenue – 3 Influences

- **Influence 1: Payer Discounts**
 - Difference between what we charge and what the payer allows
 - $\text{Payer Discount} = \text{Total Charges} - \text{Payer Allowed Amount}$

- **Influence 2: Uncompensated Care**
 - Uninsured discount
 - Charity care
 - Bad Debt

- **Influence 3: Additional Considerations**
 - Denials
 - Other write-offs



Net Revenue – Payer Reimbursement

- **Reimbursement for the same service may vary by payer**
 - Reimbursement Amount
 - Reimbursement Methodology
 - “Charge Dependency”

- **3 Types of Payers**
 - Government
 - Contracted
 - Other – commercial, worker’s comp, self-pay
 - Payer Mix is important!



Net Revenue - Government Payers

- **Medicare**
 - For people age 65 and older, people under age 65 with certain disabilities, and people of all ages with end stage renal disease
 - Federally administered by Centers for Medicare and Medicaid Services (CMS)
- **Medicaid**
 - For certain low-income individuals and families who meet federal and state eligibility requirements
 - State administered program by Minnesota Department of Human Services (DHS)
- **Payment Amount set by legislation**
- **Charge Dependency: Little to none**



Net Revenue – Contracted Payers

- **Many Contracted Payers**
- **Negotiated Payment Amount**
- **Charge Dependency**
 - Varies by payer
 - More common with inpatient outlier cases and outpatient services



Accounts Receivable Reserve Model

- **Monthly Accounts Receivable Reserve Model analysis and adjustments:**
 - Current receivables classified by payer and payer discounts recorded (i.e., Medicare, Blue Cross)
 - Self Pay accounts analysis review for bad debt (typically modeled based on historical analysis & aging)
 - Uninsured discount and Charity Care analysis (based on historical analysis)



Other Areas of Estimate & Judgment

- **Determine if a liability is probable and reasonably estimatable**
 - Professional liability (use of actuary)
 - Self Insurance liabilities (use of actuary)
 - Third Party Settlements (govt & managed care)
 - Pension liability (use of actuary)
 - Regulatory reserves (work closely with Chief Compliance Officer)



Healthcare is Capital Intensive

- **Capital budget is typically a large % of free cash flow and in some years, additional capital is funded through leases, issuance of tax-exempt debt or funded by philanthropy**
- **Capital spending should be linked to organizational strategy**
- **Cost of capital is spread over time and is reflected as depreciation expense**



Importance of Cash

- **There are several challenges not-for-profit health systems face that warrant the need for adequate cash reserves**
 - Unpredictable Cash Flows
 - Capital Intensive Industry
 - Highly Competitive Industry
 - Changing Technology
 - Fulfilling a Not-for-Profit Hospital's Mission
 - Bond credit rating
 - Debt covenants



Days Cash on Hand

■ Calculation example

- Cash & Investments = \$720 million
- Operating Expenses = \$2,968 million
- Depreciation Expense = \$160 million
- Days= 365

- Average Daily Expense = Operating Expense less Depreciation
 $(\$2,968 - 160)/365 = \7.7 million

- Days Cash on Hand = Cash & Investments (\$720)/Average Daily Expense(\$7.7) = 94 DCOH



Investment Valuation is Market Value

- **Healthcare organizations that issue tax-exempt debt hold cash & investments on their balance sheet**
- **Typically have a long-term investment portfolio that is invested in many asset classes including bonds, equities and maybe hedge funds**
- **Investment valuation is at market – must be marked to market value so will fluctuate with market conditions**



Non-Profit Can Issue Tax – Exempt Debt

- **Non-profit organizations have the ability to issue tax-exempt bonds**

- **Features**
 - Low cost source of funds
 - Limited to eligible projects
 - Match life of assets to life of issue

- **Debt Leverage Ratio = Debt divided by Debt & Unrestricted Net Assets**



Credit Profile - What Lenders want to know

- **Liquidity**
 - Days Cash on Hand
- **Profitability**
 - Operating Margin
- **Capital Structure Ratios**
 - Leverage
 - Debt service coverage



Earnings Measures

- **Board/Finance Committee approved goal**
 - X % Operating Margin
- **Operating Margin calculation:**
 - Operating Earnings/Net Operating Revenue
- **Net income**
 - Operating earnings and non-operating earnings (typically investment gains/losses)



Financial Controls

- **Annual operating and capital budget – reviewed, approved and actual is monitored against it**
- **Policies & procedures – segregation of duties, recording of revenue, cash controls**
- **External audit – should be minimal adjustments and reclassifications and management letter comments**
- **Tone at the Top - Mission/Vision/Values**



External Audit – Audit & Compliance Committee

- **Unmodified opinion – financial statements present fairly the financial condition**
- **Adjustments and reclassifications – how many and why?**
- **Management letter deficiencies and comments – what are they and what is management’s response, are any repeated from prior year? Are they material weaknesses, significant deficiencies or other**
- **Executive session without management held by Audit & Compliance Committee**




Top Accounting Issues

- **ACA and Medicare and Medicaid revenue model uncertainty**
 - pay for performance or value based purchasing?
 - charity care?
- **Implementation of new revenue recognition accounting rules**
- **Implementation of new lease accounting rules**

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Revenue Model Uncertainty



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Revenue Recognition

- Coming standard
 - Recognize revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for goods or services to a customer
 - Deferral until Dec 15, 2017 – – (start January 1, 2018) (non-public 2019)
 - “full retrospective” or “modified retrospective”



Revenue Recognition

Five Step Model

1. Identify the contract(s)
2. Identify the separate performance obligations
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations
5. Recognize revenue when the entity satisfies a performance obligation



Leases

- All leases over 12 months recognized on B/S as asset and liability
- Type A (as financing) and Type B (straight line expenses as operating)
- Expected to start January 1, 2019 (if issue bonds) or 2020 (other NFP)
- Need to start
 - Develop an inventory of existing leases.
 - Discuss with bond counsel the potential impact on bond and other debt agreements.
 - Evaluate current capital acquisition strategies and potential alternatives to new and/or existing agreements.



Conclusions

- **Healthcare accounting is complex...**
 - There are numerous areas of estimates and judgments, particularly liabilities where actuaries are required
 - Gross and net revenue accounting is complicated and requires accounting reserve models to determine what is owed and collectible
 - Cash management is a major factor in healthcare and investments are valued at market so will fluctuate with market conditions



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