

CHAPTER 16

Current Asset Management and Financing

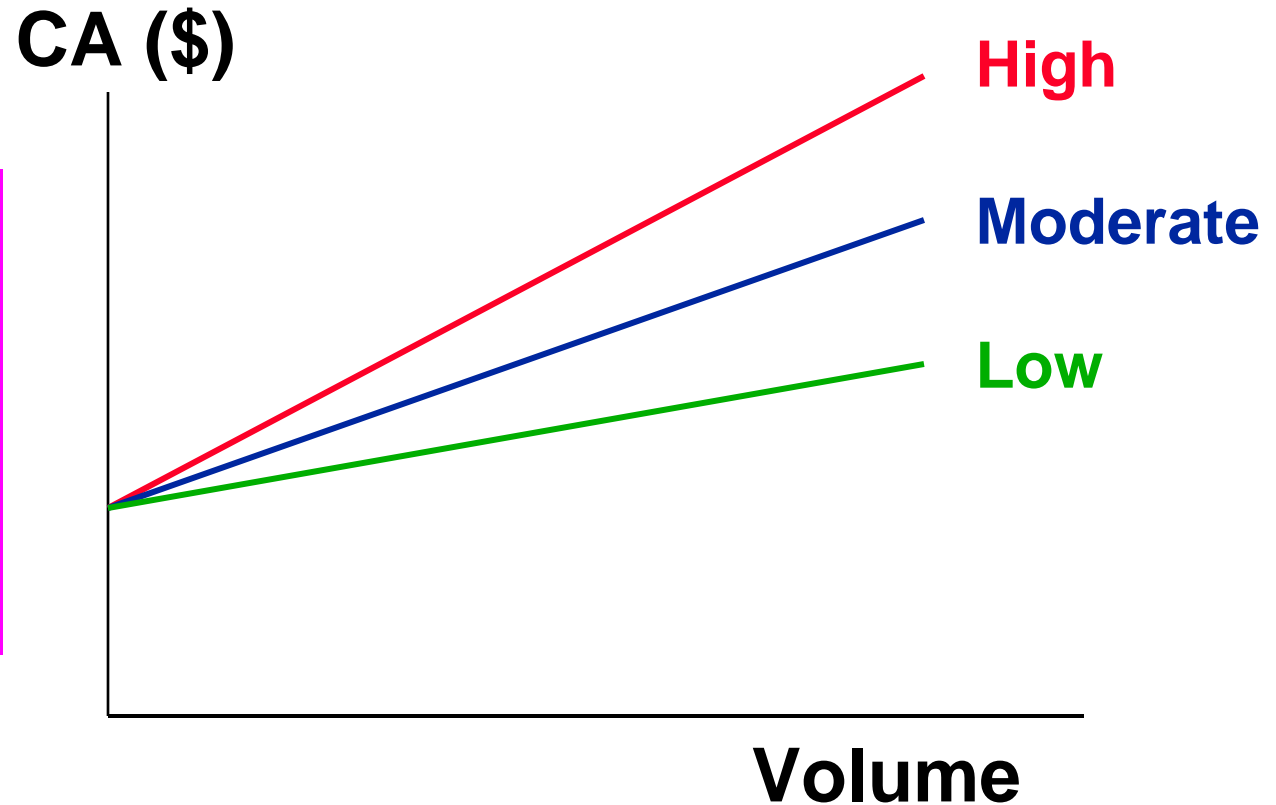
- **Investment and financing policies**
- **Cash and marketable securities management**
- **Receivables and supply chain (inventory) management**
- **Short-term financing**

Short-Term Financial Management

- **Short-term financial management** involves *all* current asset and current liability accounts (except current maturities of long-term debt).
- The primary *goal* of short-term financial management is to support operations at the lowest possible cost:
 - Must ensure *liquidity*.
 - Must have sufficient current assets to *adequately* support operations.

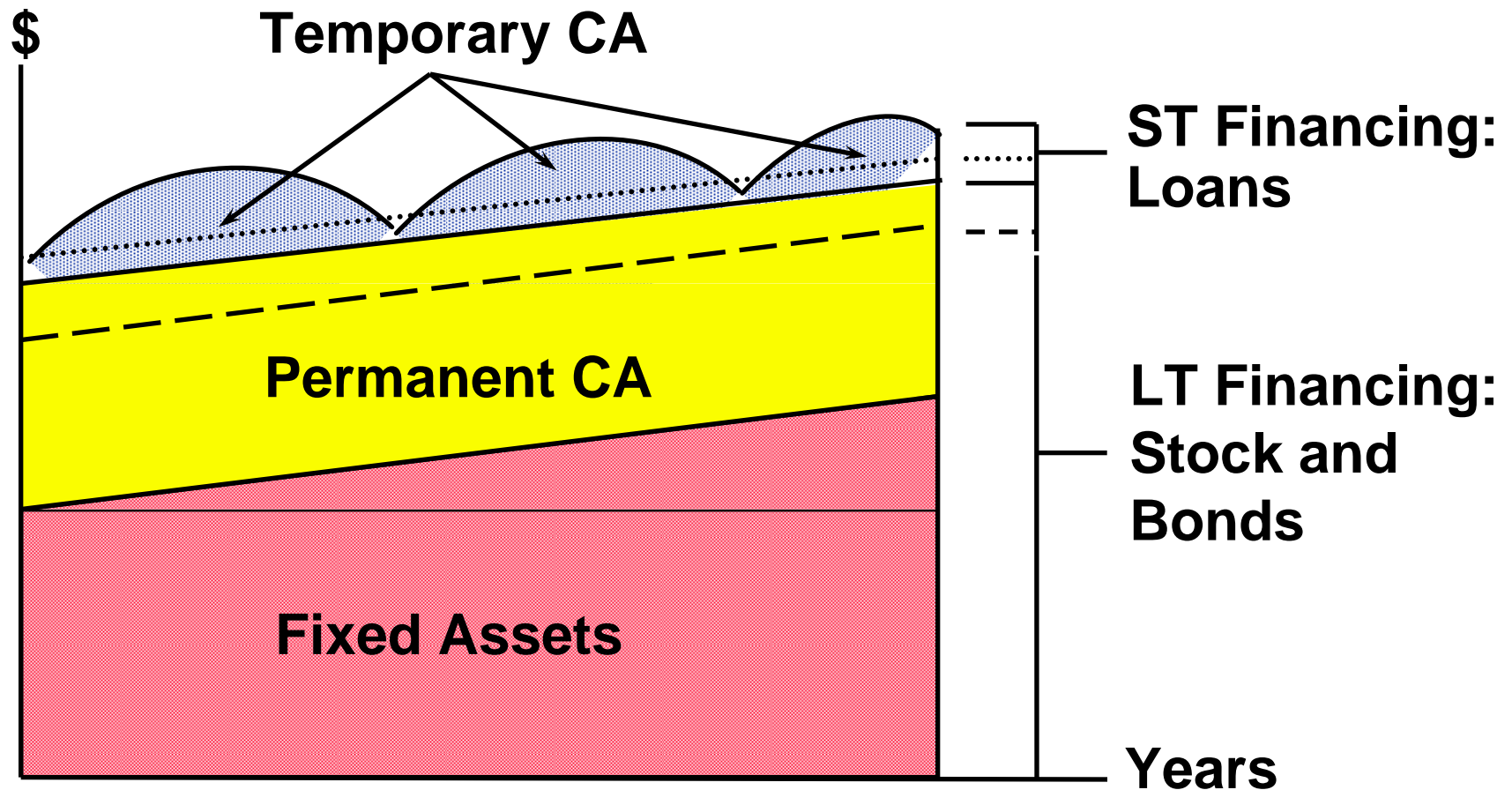
Current Asset Investment Policies

? What policy would be used in a world of certainty?



Current Asset Financing Policies

- **Moderate.** Matches the maturity of the assets with the maturity of the financing.
 - Uses *permanent capital* to finance *permanent assets*.
 - Uses *temporary financing* to finance *temporary assets*.
- **Aggressive.** Uses short-term financing to finance *permanent assets*.
- **Conservative.** Uses *permanent capital* to finance temporary assets.



Lower dashed line, more *aggressive*. Why?

Higher dotted line, more *conservative*. Why?

Cash Management

- The goal of cash management is to hold the *minimum amount* necessary to meet **liquidity** requirements. Why?
- The primary cash management technique is **float management**:
 - Acceleration of receipts
 - Disbursement control
- The cost of cash management initiatives must be balanced by corresponding benefits.

Float Management

- **Net float** is the difference between the cash amount on the firm's books and the amount on the bank's books.
 - Suppose Family Healthcare writes **\$2,000** in checks daily. It takes **six** days for these to be received and clear the banking system, so its **disbursement float** is **\$12,000**.
 - Family Healthcare receives **\$3,000** in checks daily, which are cleared in **three** days. Thus, its **collections float** is **\$9,000**.
- Its net float is $\$12,000 - \$9,000 = \$3,000$.

Acceleration of Receipts

- Net float is maximized by accelerating receipts and slowing disbursements.
- Some techniques used for **receipt acceleration** are:
 - Deposit checks received daily
 - Lockboxes
 - Concentration banking
 - Automated clearinghouses
 - Federal Reserve wire system

Disbursement Control

- **Disbursement control** is the “flip side” of receipt acceleration.
- **Some techniques used for disbursement control are:**
 - **Payables centralization**
 - **Master and zero-balance accounts**
 - **Controlled (remote) disbursement**

Short-Term Securities Management

- Businesses hold **short-term (marketable) securities** for two primary reasons:
 - As an interest-earning *substitute for cash*.
 - As a *temporary repository* for cash being accumulated to meet a specific need.
- In reality, cash and short-term securities management are accomplished simultaneously.

Short-Term Securities (Cont.)

- In general, short-term securities are chosen on the basis of *safety*.
 - Protection of principal is primary
 - Amount of return is secondary
- Specific securities used depend on the:
 - Expected holding period
 - Size of the business
- Some examples are:
 - Short-term Treasury securities
 - Money market funds

Long-Term Securities Management

- Although for-profit providers generally do not hold **long-term securities**, not-for-profit providers often hold large amounts:
 - To accumulate funds for fixed asset investment (**funded depreciation**).
 - To hold endowment and retirement funds.
- In general, businesses are much more aggressive in their long-term security investments than in their short-term investments. Why?

Receivables Management

- If a service is provided for cash, the revenue is immediately received.
- If the service is provided on credit, the revenue is not received until the receivable is collected.
- **Receivables management** is extremely important to healthcare providers.

? Why?

Accumulation of Receivables

- Suppose Valley Clinic contracts with an insurer whose patients use **\$2,000** in services daily and who pays in **20** days.
- The clinic will accumulate receivables at a rate of **\$2,000** per day.
- However, after **20** days, the receivables balance will stabilize at **\$40,000**:

$$\begin{aligned} A/R &= ADS \times ACP \\ &= \$2,000 \times 20 = \$40,000. \end{aligned}$$

Cost of Carrying Receivables

- Suppose Valley Clinic uses bank financing that has an interest rate of **10%** to finance its receivables.
- The annual cost of carrying the receivables is **\$4,000**:

$$\$40,000 \times 0.10 = \$4,000.$$

? What factors influence the dollar cost of carrying receivables?

Monitoring Receivables

- It is important that healthcare managers continuously *monitor* the firm's receivables.
- Monitoring methods include:
 - **Average collection period (ACP)**, often called days in patient accounts receivable
 - **Aging schedules**
- Receivables are monitored both in the aggregate and by specific payer.

Supply Chain (Inventory) Management

- Although important, **supply chain management** is not as important for providers (service firms) as it is for manufacturers, wholesalers, or retailers. Why?
- Inventories consist of **base stocks** plus **safety stocks**.
- The goal of inventory management is to meet operational needs at the lowest cost.

Inventory Management (Cont.)

- **Some inventory management techniques now being used by providers include:**
 - **Just-in-time (or stockless) systems**
 - **Point of distribution systems**
- **In addition, some providers have contracts with suppliers that are priced on the basis of the amount of medical services provided or even capitated.**

The Revenue Cycle

- In the management of short-term assets, providers typically think in terms of the **revenue cycle**.
- It is defined as those activities associated with billing and collecting for services.
- For example, consider the activities on the following slide.

The Revenue Cycle (Cont.)

- **Before-service activities:**
 - Preinsurance verification
 - Precertification of managed care patients
 - Preservice patient financial counseling
- **Service activities:**
 - Time of service verification
 - Claims production
- **Post-service activities:**
 - Claims submissions
 - Third-party follow-up (if needed)
 - Denials management
 - Monitoring and reporting

The Revenue Cycle (Cont.)

- In revenue cycle management, each of the identified activities is closely monitored to ensure that:
 - The *correct amount* of reimbursement is collected on each patient.
 - Reimbursements are collected as *quickly* as possible.
 - The costs associated with the revenue cycle are *minimized* consistent with rapid and correct collections.
- Two important keys to good revenue cycle management are **information technology** and **electronic claims processing**.

Short-Term Financing

- **Short-term financing** has three primary advantages over long-term.
 - Lower issuance costs
 - Fewer restrictive covenants
 - Generally lower interest rate
- **Major sources for providers**
 - Accruals
 - Accounts payable (trade credit)
 - Bank loans (notes payable)
- ? **Are there any disadvantages?**

Accruals

- **Accruals** consist primarily of *wages* owed to employees and *taxes* owed to governments.
- Accruals are *free* in the sense that no explicit interest is charged.
- However, managers have little *control* over the level of accruals, which is influenced more by industry custom and tax laws.
- ? Do not-for-profits have accrued taxes?
- ? What is a good accrual policy?

Accounts Payable (Trade Credit)

- **Trade credit** is credit furnished by a business's *suppliers*.
- Trade credit often is the largest source of short-term credit, especially for small businesses.
- Both accruals and trade credit are **spontaneous liabilities** in the sense that their levels change *spontaneously* as patient volume rises and falls.

Northwest Healthcare buys \$3,000,000 (invoice price) of medical supplies from one of its vendors on terms of 2/10, net 30. How much trade credit is available from this vendor, and how much does it cost?

Gross/Net Breakdown

- Northwest buys supplies *worth* \$3,000,000 x 0.98 = **\$2,940,000** because that is the *net*, or *cash (true), price*.
- If Northwest does not take the discount, it must pay **\$3,000,000** for the supplies. This is the *gross*, or *invoice, price*.
- The difference, **\$60,000**, is a **financing cost** similar to the dollar amount of interest paid on a loan.

Net daily purchases (NDP)

$$\text{NDP} = (\$3,000,000 \times 0.98) / 360 = \$8,167.$$

Payables level with discount

$$\text{Payables} = \$8,167 \times 10 = \$81,670.$$

Payables level without discount

$$\text{Payables} = \$8,167 \times 30 = \$245,010.$$

Credit breakdown

$$\text{Total trade credit} = \$245,010$$

$$\text{Free trade credit} = 81,670$$

$$\text{Costly trade credit} = \underline{\underline{\$163,340}}$$

Approximate Cost Rate of Costly Trade Credit

Northwest must pay **\$60,000** to obtain **\$163,340** in extra trade credit, so

$$\text{Cost rate} = \frac{\$60,000}{\$163,340} = 0.367 = 36.7\%.$$

But the **\$60,000** in “financing charges” is paid throughout the year rather than at year end, so the ***EAR*** is even higher.

Approximate Cost Formula

$$\begin{aligned}\text{Cost} &= \frac{\text{Discount \%}}{1 - \text{Discount \%}} \times \frac{360}{\text{Days taken} - \text{Discount period}} \\ &= \frac{2}{98} \times \frac{360}{30 - 10} = 0.0204 \times 18 \\ &= 0.367 = 36.7\%.\end{aligned}$$

Effective Annual Rate

$$\text{Periodic rate} = 2 / 98 = 0.0204.$$

$$\text{Periods / year} = 360 / (30 - 10) = 18.$$

$$\begin{aligned} \text{EAR} &= (1 + \text{Periodic rate})^M - 1.0 \\ &= (1.0204)^{18} - 1.0 = 0.438 = 43.8\%. \end{aligned}$$

What Should Northwest Do?

- Northwest should take the **\$81,670** in free trade credit—it should take all the free trade credit that it can get.
- However, it should take the costly trade credit *only* if the implied cost is less than the cost of alternative financing sources.
- Because Northwest can obtain bank loans at a **10%** rate, it should *not* take the **\$163,340** in costly trade credit.

Bank Loans

- **Commercial banks** are important sources of short-term credit to healthcare providers (especially smaller businesses).
- Bank loans appear on the balance sheet as **notes payable**.
- Bank loan concepts
 - Promissory note
 - Compensating balance
 - Line of credit

Secured Short-Term Loans

- In a secured loan, the borrower pledges assets as *collateral* for the loan.
- For short-term loans, the most commonly pledged assets are **receivables** and **inventories**.
- ? What about pledging fixed assets or marketable securities?

Receivables Financing

- If receivables are **pledged**, the lender has **recourse** to the borrowing provider.
- When receivables are **factored**, they are effectively sold, and the buyer (lender) has **no** recourse to the selling (borrowing) business.

Inventory Financing

- **Healthcare providers are more likely to use receivables financing than inventory financing.**
- **If inventory financing is used, the inventory may be secured by a:**
 - **Blanket lien**
 - **Trust receipt**
 - **Warehouse receipt**
- **The form used depends on the type of inventory and situation at hand.**

Conclusion

- This concludes our discussion of *Chapter 16* (Current Asset Management and Financing).
- Although not all concepts were discussed in class, you are responsible for all of the material in the text.
- ? Do you have any questions?