

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**

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 three most important are:
 - Income statement
 - Balance sheet
 - Statement of cash flows

Introduction to Financial Acct. (Cont.)

- 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?

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 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?

Measuring and Recording of Economic Events

- **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?

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 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**.

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

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.
 - **Net income (profit)** = Revenues - Expenses.

Sunnyvale Clinic: Revenues

(in thousands)

	<u>2007</u>	<u>2006</u>
Revenues:		
Net patient service revenue	\$169,013	\$140,896
Other revenue	<u>7,079</u>	<u>5,704</u>
Total revenues	<u>\$176,092</u>	<u>\$146,600</u>

Revenues

- **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?

Discussion Item

Some years ago, patient service revenue was reported using this format:

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

*Based on charges

? Is the old way or the new way better?

Sunnyvale Clinic: Expenses

(in thousands)

	<u>2007</u>	<u>2006</u>
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
Provision for bad debts	2,000	1,800
Interest	5,329	3,476
Total expenses	<u>\$168,232</u>	<u>\$138,394</u>

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.
- ? Which classification system is better?
- ? Which system does Sunnyvale use?

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 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**
 - 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?

Expenses (Cont.)

- **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.

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 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**.

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 (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)

	<u>2007</u>	<u>2006</u>
Revenues:		
Total revenues	<u>\$176,092</u>	<u>\$146,600</u>
Expenses:		
Total expenses	<u>\$168,232</u>	<u>\$138,394</u>
Net income	<u><u>\$ 7,860</u></u>	<u><u>\$ 8,206</u></u>

Net Income

- 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

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.
 - The remainder is reinvested in the business.

Net Income (Cont.)

- 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?

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 are greater than ownership differences.

An Introduction to Financial Statement Analysis

- In **financial statement analysis**, values may be combined to form *ratios* that have easily interpretable economic meaning.
- For example, **total (profit) margin**:

$$\begin{aligned}\text{Total margin} &= \frac{\text{Net income}}{\text{Total revenue}} \\ &= \frac{\$7,860}{\$176,092} = 0.045 = 4.5\%.\end{aligned}$$

? How is this ratio interpreted?

Conclusion

- 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?