

TABLE 13-4 Financial Planning Assumptions for OHF Years 20X3 to 20X7

Account	Assumptions
Revenues	
Net patient revenue	2% growth per year
Equity in partnerships	5% growth per year
Gifts and bequests	5% growth per year
Other	5% growth per year
Expenses	
Interest expense	7.5% of prior year long-term debt + current maturities of long-term debt
Salaries and wages	1% growth per year
Fringe benefits	23% of salaries and wages
Professional fees	5% growth per year
Supplies	5% growth per year
Restructuring costs	\$2,078,000 in 20X7; zero thereafter
Depreciation expense	5.8% of gross property and equipment
Bad debt expense	2.8% of net patient revenue
Nonoperating gains	
Investment income	8.3% of beginning balance in board-designated and funded depreciation
Gifts and bequests	\$50,000 per year
Loss on disposals	\$100,000 per year
Assets	
Cash and short-term investments	20 days cash on hand
Accounts receivable	15% of net patient revenue
Due from donor-restricted funds	\$300,000 per year
Current portion held by trustee	Increasing by \$65,000 per year
Current portion self-insurance	5% growth per year
Inventory and prepaid expenses	5% growth per year

(continues)

TABLE 13-4 Financial Planning Assumptions for OHF Years 20X3 to 20X7 (continued)

Account	Assumptions
Total current assets	Subtotal of previous items
Gross property and equipment	Net new capital expenditures of \$10,000,000 per year
Accumulated depreciation expense	Beginning balance + depreciation expense
Self-insurance trust	5% growth per year
Board-designated and funded depreciation	Balancing account, all surplus cash flow will be invested here
Funds held by trustee	\$338,000 per year
Investments in partnerships	5% growth per year
Deferred financing costs	Schedule: \$972,000 in 20X7, decreasing by \$167,000 per year
Other assets	10% growth per year
Liabilities	
Current maturities of long-term debt	Schedule based on debt principal due in Table 13-9
Accounts payable	5% growth per year
Accrued salaries and wages	5.3% of salaries and wages expense
Accrued restructuring costs	Value goes to zero in 20X7 and remains at zero
Accrued vacation	Stable at \$3,288,000
Accrued insurance costs	5% growth per year
Advances from third-party payers	0.75% of net patient revenue
Due to third-party payers	7.2% of net patient revenue
Total current liabilities	Subtotal of previous items
Long-term debt	Schedule based on payment of debt principal in Table 13-9
Accrued retirement costs	5% growth per year
Accrued insurance costs	5% growth per year
Deferred third-party reimbursement	Stable at \$3,489,000
Other liabilities	5% growth per year
Unrestricted net assets	Addition of net income to prior balance

TABLE 13-7 Forecasted Financial Ratios for OHF

	20X7	20X8	20X9	20X0	20X1
Profitability					
Total margin percentage	3.9	4.9	4.9	5.0	5.0
Operating margin percentage	1.3	2.3	2.0	1.7	1.4
Nonoperating revenue %	2.6	2.9	3.0	3.2	3.5
ROE percentage	8.2	9.7	8.8	8.5	8.0
Liquidity					
Current	1.11	1.11	1.09	1.09	1.09
Days in accounts receivable	54.8	54.8	54.8	54.8	54.8
Days cash on hand (short term)	20.0	20.0	20.0	20.0	20.0
Capital structure					
Equity financing percentage	44.1	46.4	48.7	50.9	53.0
Long-term debt to equity %	63.3	55.6	49.1	43.2	38.4
Cash flow to debt percentage	14.9	17.4	18.0	18.8	19.6
Times interest earned	2.65	3.19	3.31	3.43	3.59
Activity					
Total asset turnover	0.93	0.91	0.89	0.87	0.85
Fixed asset turnover	2.32	2.37	2.43	2.52	2.63
Current asset turnover	4.44	4.44	4.44	4.44	4.44
Other ratios					
Average age of plant	8.8	9.3	9.7	10.2	10.7

high price structure, which it may not be able to maintain. A 2% growth rate is predicated on zero growth in net prices but a 2% growth in volume of services. A 2% growth in services seems reasonable given previous growth in outpatient and clinic services. The assumptions made about revenue growth (volume and price) are the most important variables in terms of impact on the financial plan. Small changes in these assumptions can have a sizable influence on projected financial results.

- **Salaries and wages:** In the labor intensive healthcare industry the second most important assumption in any financial forecast is salaries and wages. Salary and wage cost are the product of three factors:

$$\text{Salary and wage costs} = \text{Volume of services} \\ \times \text{Staffing ratios} \times \text{Wage rates}$$

OHF has poor productivity and has undergone massive restructuring to try to reduce given staff levels and

Integration of the Financial Plan with Management Control

The development of a financial plan is a useless exercise unless that plan is integrated into the management-control process. Management needs to know whether the plan is being realized and, if it is not, what corrective action can be taken. In some cases there may be little that management can do. For example, assume that the entity has experienced an unusually large reduction in its operating margins as a result of declining prices due to increased competition. In this case the only course of action open to management is perhaps to revise its plan to reflect more accurately the current situation or to cut expenses if possible. Indeed, it is important for management to assess the accuracy of its financial plan annually and to make appropriate changes as needed.

To integrate the financial plan with the management-control process, some structure is needed. Financial ratios provide that structure. The chart in **FIGURE 13-4** depicts detailed targets for OHF, reflecting its financial plan. In the chart specific ratio values are delineated. The primary targets involve the four major ratios that together determine the hospital's ROE. The secondary targets are concerned with additional data that can be used to monitor actual performance and detect possible problems.

To understand how the chart in Figure 13-4 might be used in management control, let us assume that the year 20X7 has just ended and the financial data essential to the calculation of the ratios are now available. OHF's actual ROE for 20X7 is assumed to be 7.6%, which represents an unfavorable variance from the required value of 8.4%.

Actual 20X7 values for the primary indicators are as follows:

Operating margin ratio percent, 1.0
Total asset turnover ratio, 0.93
Equity financing ratio percent, 44.0
Nonoperating revenue percent, 2.6

The major cause of the **unfavorable variance** in ROE deviates from the expected operating margin of 1.3 to 1.0%. In addition, the nonoperating revenue ratio also was below expectations, with an actual value of 2.6% compared with an expected value of 2.7%. All other ratio targets that determine equity growth were met. This narrows any corrective actions to the two areas of operating margins and nonoperating gains.

It is extremely important to remember the concept of sustainable growth. (This concept was introduced in Chapter 11.) Sustainable growth simply means that no organization can generate a growth rate in assets that exceeds its GRIE for a prolonged period. Ultimately, an organization is limited by the rate at which it can generate new equity.

ROE can be defined as follows:

$$ROE = \frac{[OM + NOR] \times TAT}{EF}$$

where OM is the operating margin ratio, NOR is the nonoperating revenue ratio, TAT is the total asset turnover ratio, and EF is the equity financing ratio. If top management and board members concentrate on this simple formula and the key relationships it represents, financial focus and direction will improve dramatically.

SUMMARY

In the process of identifying the requirements for effective financial policy formulation in healthcare

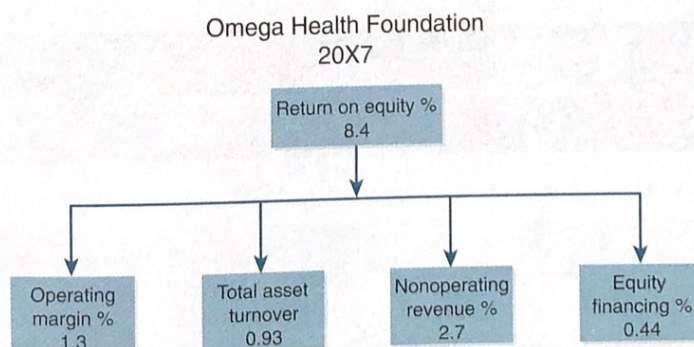


FIGURE 13-4 Financial Ratio Targets for Omega Health Foundation