Documents" in the Back-of-Book CD-ROM. SouthSide Hospital appears to maintain its reputation in the community, given the lack of change in the category for other assets.

The considerable investment in fixed assets underscores the community-oriented perspective, non-profit tax status, and organizational priorities of SouthSide Hospital. It appears to be a management priority to reduce the amount of long-term debt, as it has decreased by $2,108,000 between FY 2001 and FY 2003. The increase in net assets reflects a focus on community-based programs such as breast cancer screening for underserved women; this increases opportunities to receive restricted grant funds.

The Balance Sheet and the Income Statement

Box 10-3 summarizes how the balance sheet and income statement are related to each other. These relationships are mentioned throughout this section. The balance sheet and income statement are also closely related to the statement of cash flows.

The Statement of Cash Flows

Over the short term, the financial condition (and survival) of an organization depends more on cash flow than on profits (see Chap. 4). Bankruptcy can occur with positive income; in other words, profitable enterprises can go bankrupt if they run short of cash. It is therefore essential to forecast cash flow, prepare cash flow budgets (see Chap. 6), and report the flow of cash in and out of the organization.

With accrual accounting (used in most health care organizations), neither revenue nor net income equals cash inflow. In addition, expenses do not equal cash outflow. For example, while depreciation is recorded as an operating expense in the income statements and as a deduction from fixed assets in the balance sheet, it is not actually paid out in cash. Therefore, it is important to review the statement of cash flows (also referred to as the **cash flow statement**), which focuses on financial condition based on cash flow rather than revenues, expenses, or net income. The statement of cash flows provides information about the sources and uses of cash and cash resources. It is a useful management tool that helps prevent liquidity problems, thus protecting the enterprise from cash flow difficulties and the threat of bankruptcy. The following section explains how the statement of cash flows is linked to the balance sheet and the income statement.

BOX 10-3

Linking the Balance Sheet to the Income Statement

- For non-profits, net income equals reinvestment, so a change in net assets on the balance sheet should equal net income in the income statement.
- For for-profits, the amount reinvested in the business equals net income less dividends paid to stockholders, so the change in equity on the balance sheet should equal the retained earnings (net income less dividends) on the income statement.
- Accumulated depreciation is a contra-asset account on the balance sheet because it is a negative asset—the higher the accumulated depreciation, the smaller the organization's fixed and total assets. On the income statement, depreciation is entered as an operating expense.
- IBNR expenses are reported as a current liability on the balance sheet and an operating expense on the income statement.
- Increased revenues increase assets but also generally increase expenses and liabilities, as more inputs are required for higher volume.

The Statement of Cash Flows, Balance Sheet, and Income Statement

The statement of cash flows uses data from both the balance sheet and the income statement to show the relationship between cash flow and earnings. Remember that the basic accounting formula is represented in the layout of the balance sheet:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

$$A = L + E$$

This equation can be expanded to show the components of current and non-current assets and liabilities:

$$\text{Current Assets} + \text{Non-current Assets} = \text{Current Liabilities} + \text{Non-current Liabilities} + \text{Owners Equity},$$

or:

$$CA + NCA = CL + NCL + OE$$

It is then possible to break the equation down by showing the components of current assets:

$$(\text{Cash} + \text{Accounts Receivable} + \text{Inventory}) + NCA = CL + NCL + OE$$

Note that an increase in current liabilities (CL) increases the amount of cash available, and increasing assets such as accounts receivable or inventory reduces the amount of cash available. In other words, the more money owed to an organization (accounts receivable), the less cash it has on hand, and the more it has invested in inventory purchases, the less cash it has available. A key purpose of the statement of cash flows is illustrating the relationship between cash, liabilities, and assets.

Recall the example of Paul Jackson, the Director of Central Supply at SouthSide Hospital, who approved the purchase of 300,000 pairs of sterile latex gloves for patient care. The order was prepaid in February 2001 and received in March 2001, and the gloves were used within the second quarter (April through June) of 2001. Assume the order of 300,000 pairs of sterile latex gloves costs $45,000. Table 10-9 presents the scenario of prepayment of $45,000 for the gloves in February 2001 in the first column of balance sheet figures. In the current assets section, $45,000 in cash (the prepaid amount for the gloves) is reduced, replaced with an equal increase in the amount of prepaid expenses. Within the liabilities and equity section, nothing is entered for accounts payable as the transaction is prepaid (other transactions that might affect prepayment or accounts payable are omitted for simplicity), and total net assets (equity) is $745,000.

TABLE 10-9

SouthSide Hospital, Balance Sheet Scenarios, Central Supply Department Prepaid Expenses vs. Account Payable, $ thousands, February 2000

	Prepaid Scenario	A/P Scenario
Cash	$100	$145
Prepaid Expenses & Other	45	0
All Other Current Assets	745	745
Total Current Assets	**$890**	**$890**
All Other Assets	**$2,030**	**$2,030**
Total Assets	**$2,920**	**$2,920**
Accounts Payable	$0	$45
All Other Current Liabilities	$590	$590
Total Current Liabilities	**$590**	**$635**
Other Liabilities & LT Debt	**$1,585**	**$1,585**
Total Net Assets	**$745**	**$700**
Total Liabilities & Net Assets	**$2,920**	**$2,920**

BOX 10-4

Linking the Balance Sheet to the Income Statement and the Statement of Cash Flows

1. Increases in cash flows from operating activities reflect increases in net income (income statement), depreciation and amortization (income statement), current liabilities (balance sheet), and decreases in current assets (balance sheet).
2. Capital investments are a use of cash, so increases in gross fixed assets decrease cash flow (balance sheet).
3. Financial investments are a use of cash, so increasing marketable securities and long-term investment reduces cash, while increasing notes payable and long-term debt increases cash (balance sheet).
4. The net change in cash should balance as the sum of cash flows from operating activities, capital investing, and financing (statement of cash flows), and as the difference between the beginning and ending cash amounts (balance sheet).

Now assume a second scenario for comparison and to reinforce the relationships between cash, other assets, liabilities, and equity. Paul orders the 300,000 pairs of sterile latex gloves for $45,000 in February 2001, but the vendor bills for payment due the following month. This scenario is illustrated in the second column of balance sheet figures in Table 10-9. The amount of cash and accounts payable both increased by $45,000, while the prepaid expenses dropped by the same amount. Total net assets also dropped by $45,000, as this amount would be payable upon bankruptcy before any remaining assets could be returned to the community (as required of a non-profit in the event of liquidation).

Box 10-4 summarizes the relationships between the balance sheet, the income statement, and the statement of cash flows.

Sections of the Statement of Cash Flows

The statement of cash flows is a report of the cash sources and cash requirements for three categories of financial management: operating activities, investing activities (also referred to as capital investing), and financing activities. The cash flow, or net increase or decrease in cash, is reported for each of these three activities, which appear as sections of the statement of cash flows. The reviewer should evaluate if the business is generating enough cash to cover operating, capital investing, and financial investing expenses.

The statement of cash flows for SouthSide Hospital shown in Table 10-10 reports cash activity for FY 2002 and FY 2003 (to show change in cash flow from year to year, the prior fiscal year's data are required). The SouthSide Hospital income statement and balance sheet show changes in each of the entries for FY 2001–2002 and FY 2002–2003 used in the preparation of the statement of cash flows (see "Supplemental Tables and Documents" on the Back-of-Book CD-ROM).

Cash Flows From Operating Activities The first section of the statement of cash flows reports cash increases or decreases that are directly related to operations. The most important entry is net income, which for FY 2002 is $3,062,000. Net income does not equal cash flow, so a number of adjustments must be made to net income. First, the estimated expense amounts for depreciation and amortization, $2,889,000 in FY 2002, are added back to net income, as they represent non-cash accruals. In other words, no cash payments are ever actually made to accounts for depreciation and amortization, so this entry is an expense but not an actual use of cash. The net income, adjusted for depreciation and amortization, is $5,951,000 for FY 2002.

Adjustments are then made to the working capital, reflecting cash flows related to operations. These are placed in categories of changes in current assets (increases in current assets decrease the amount of cash) and changes in current liabilities (increases in current liabilities increase cash amounts) for easier understanding and interpretation. The first entries are a change in net accounts receivable of $414,000 in FY 2002, a change in inventories of $33,000, and a change in prepaid expenses (such as the lease and utilities) of $29,000. Changes in current liabilities for FY 2002 include $186,000 in accounts payable and a $659,000 increase in accrued expenses.

The changes in current assets are subtracted from the line for net income and non-cash transfers and changes to current liabilities are added for a net amount of cash from operating activities of $6,320,000 for FY 2002. In other words, SouthSide Hospital had a net cash inflow from operating activities of $6,320,000 in FY 2002.

TABLE 10-10

SouthSide Hospital, Statement of Cash Flows, $ thousands, FY 2002 and FY 2003

	FY 2002	FY 2003
Cash Flows from Operating Activities:		
Net Income	$3,062	$3,757
Add Back Depreciation & Amortization	2,889	2,950
Net Income & Non-Cash Transfers	**$5,951**	**$6,707**
Adjustments to Working Capital:		
Changes in Current Assets:		
Change in Net Accounts Receivable	414	222
Change in Inventories	33	459
Change in Prepaid Expenses	29	64
Changes in Current Liabilities:		
Change in Accounts Payable	186	152
Change in Accrued Expenses	659	206
Net Cash from Operating Activities	**$6,320**	**$6,320**
Cash Flows from Investing Activities:		
Capital Expenditures (Change in Gross Fixed Assets)	**$(3,608)**	**$(2,966)**
Cash Flows from Financing Activities:		
Change in Notes Payable	18	45
Change in Marketable Securities	142	177
Change in Long-Term Investments	65	144
Change in Long-Term Debt	(1,125)	(2,108)
Net Cash from Financing Activities	**$(1,314)**	**$(2,384)**
Net Change in Cash	$1,398	$970
Cash at Beginning of Year	$1,209	$2,607
Cash at End of Year (Cash Balance)	**$2,607**	**$3,577**

Cash Flows From Investing Activities The second section of the statement of cash flows represents cash flow from investments, also referred to as capital investing. Capital investing represents investments in fixed or non-current assets, not financial investing (which is presented in the third section of the statement of cash flows). Depreciation is already recorded in the non-cash section of the operating cash flows, so it is not included in this section of the statement of cash flows. Therefore, the change in gross fixed assets (not adjusted for depreciation) for FY 2002 from the balance sheet (see Table 10-8) for capital expenditures is recorded.

The change in gross fixed assets for FY 2002 at SouthSide Hospital is a negative $3,608,000, recorded as a negative number as it represents cash outflow. In other words, SouthSide Hospital used $3,608,000 for capital investments over fiscal year 2002.

Cash Flows From Financing Activities The third section of the statement of cash flows records the flow of cash related to financing or financial investments, rather than the capital investments recorded in the second section of the statement of cash flows. The first entry for FY 2002 is $18,000 for the change in notes payable (an increase in notes payable increases the cash amount), then a $142,000 increase in marketable securities (an increase in marketable securities decreases the cash amount). A change of $65,000 is recorded for long-term investments (an increase in long-term investments decreases the cash amount) and a $1,125,000 decrease in long-term debt (an increase in long-term debt increases the cash amount, so the decrease is recorded as a negative, as it decreases the cash amount).

The net cash from financing is a negative $1,314,000 for FY 2002. In other words, SouthSide Hospital used $1,314,000 in cash for financing investments over FY 2002.

Net Cash and Cash Balance

The fourth and final section of the statement of cash flows is the calculation of net cash and the cash balance. The cash amount from operating activities ($6,320,000), the cash amount from investing activities (negative $3,608,000), and the cash amount from financing activities (negative $1,314,000) are added for a net change in cash of $1,398,000 for FY 2002. The cash at the beginning of FY 2002 ($1,209,000, which is the ending balance for FY 2001, as shown in Table 10-8) and the cash at the end of FY 2002 ($2,607,000, also shown in Table 10-8) are also entered in this section. The net change in cash must balance; in other words, the difference between the ending cash balance and the beginning cash balance for FY 2002 must equal the sum of the cash flows from operating activities, investing activities, and financing activities. The difference between the cash at the end of FY 2002 and the beginning of FY 2002 ($2,607,000 − $1,209,000) equals $1,398,000, so that the statement of cash flows balances. Figure 10-3 illustrates the calculations and balance required for the net cash flows in the statement of cash flows for SouthSide Hospital, FY 2002.

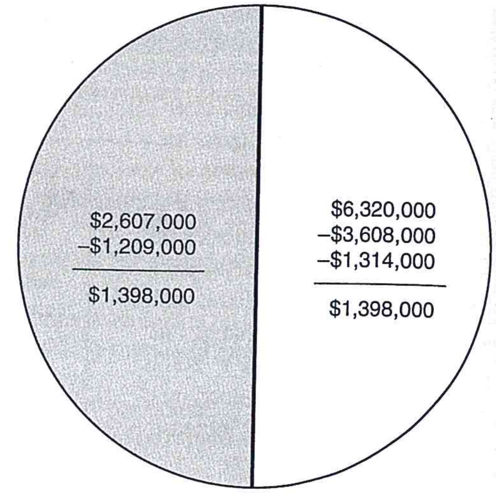

FIGURE 10.3 ■ SouthSide Hospital, Net Cash Flow Balance, FY 2002.

Interpretation of the Statement of Cash Flows

In terms of financial health, the overall cash flow for FY 2002 and FY 2003 is positive; in other words, more cash is coming into the organization than is going out, overall. The management decisions are to spend cash on capital expenditures and on reducing long-term debt (consistent with findings in the income statement and the balance sheet). There has been a substantial increase in cash, which might be better invested in marketable securities. Management should look at this trend and rethink decisions so that cash is not left sitting idle but rather is invested to generate returns.

Conclusion

This chapter introduced financial reporting concepts using the most commonly reviewed financial reports: the annual report, income statement, balance sheet, and statement of cash flows. Critical review of these reports helps in understanding the financial health and performance of a health care organization. Chapter 11 will present further concepts and methods for analyzing financial reports.

■ CRITICAL THINKING EXERCISES

1. Using the budget reports for Freeston ElderCare, and adding your own estimates as needed, prepare an income statement, balance sheet, and statement of cash flows for FY 2001.
2. Interpret the financial statements prepared for Freeston ElderCare. Is this a profitable venture? What managerial decisions and priorities are reflected in the financial statements?