



Washington State Department of Health

Accounting and Reporting Manual for Hospitals
Chapter 4000

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Budgeting Principles and Concepts
Chapter 4000

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Preface

4001

If hospitals are to provide high quality medical care at the lowest possible cost, a basic plan is essential -- a plan through which all expenditures and revenues from all sources may be forecasted and controlled. This basic plan, expressed in quantitative terms, is called a "budget".

The objective of this chapter is to present a method by which hospitals of all sizes will set up an effective budgeting program. A formal budget will also assist those responsible for hospital management to forecast the quantity and cost of services to be rendered and determine the amount and sources of the revenue necessary to provide services consistent with a desired level of patient care.

The budget, by itself, will not decide the quality and quantity of care. The preparation of a budget, however, forces thinking in terms of these functions and sharpens the decision-making process.

The hospital's budget must facilitate hospital management to control operations and also provide summary data for reporting to the Department. An analytical framework must be developed that incorporates both planning and control of operations. This Manual describes the techniques of budget preparation to serve these functions.

Prerequisites To an Effective Budget Program

4010

Since the budget is utilized to assist in the planning, coordinating, and controlling functions of management as well as reporting to the Department, it is essential that certain conditions exist in the facility to ensure the successful use of the budget. The prerequisites necessary to establish an effective budgeting system include:

Commitment to long-range planning and management of the hospital's operations: Top management must recognize the importance of planning for the hospital's future, translating the plan into a budget and using the budget as a standard to measure and influence performance.

Well defined goals and objectives: The annual objectives of the hospital must be responsive to the achievements of goals as defined by the governing board. As hospital management and succeeding levels of supervision adopt objectives and define policies that lead ultimately to attainment of the hospital's goals, a coordinated plan takes shape. Relating a budget to this plan and then comparing the hospital's performance with the budget keeps the hospital on track towards its goals, which are often long-range.

Effective organizational structure: An organizational structure within the hospital with clear and direct lines of authority is essential. All levels of hospital management should be aware of their responsibilities and the extent of their authority. It is only when authority is clearly defined that an individual can be held responsible for the activities of the department. With job descriptions and organizational lines clearly drawn, one of the major objectives of

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the budget can be more easily accomplished; i.e., to bring responsibility for costs down to the department level where they are incurred.

Responsibility accounting system with functional and natural classification visibility: The system of accounts has been prepared to insure a uniform departmental structure within the hospital. The revenue and expense accounts are related and follow the lines of responsibility to be defined in the organizational plan of the hospital. Meaningful and timely performance reports can then be provided to the department head or supervisor. Functional classification of revenues and expenses provided in the system of accounts links financial data with clinical programs and allows for the comparison internally from one year to another and externally with other hospitals. The system of accounts also provides for the reclassification of data accumulated in the hospital's responsibility oriented accounting system into functionally oriented reports for comparing hospital performance. Natural classification of operating expenses is important to the Department and the hospital to make possible more effective analysis, measurement, budgeting and cost management.

Accumulation of adequate statistical data: Adequate and uniform statistics are essential to measure the performance of a department, not just in dollars and cents, but in terms of actual measure of work performed and results produced. The standard unit of measure, as prescribed by the Department in the system of accounts, represents the measurable unit of production (output). The forecast of these units is the basis for budgeting the expenses and revenues.

Uniform budget reporting system: Effective operating controls can be developed and corrective action taken with the use of these uniform reports by the Department and hospital management. These reports should be distributed to all levels of supervision. They will provide operational data for areas of responsibility. A formal reporting system also facilitates and encourages discussions between levels of supervision and allows corrective action to be taken on a timely basis. Other internal reports should be produced to allow program monitoring and aid in long-range planning

Types Of Budgets

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Two types of budgets are used in the reporting system; forecast budgets and flexible budgets.

Forecast Budget

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The forecast budgeting method is one that may be used for operations, capital, and cash budgeting requirements. This method is an acceptable budgeting procedure. It contains estimates for only a single level of activity. The forecast budget has limited flexibility, since deviations from planned expenditures do not require formal budget changes. With planning confined to a single level of activity, however, the operational part of the forecast budget loses some of its value for control purposes if the attained level of activity deviates from the planned level of activity to any significant degree.

Flexible Budget

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The flexible budgeting method is the preferred budgeting technique, and hospitals are encouraged to use this method for their operations budget. It is built on the premise that there are certain costs that will vary with the level of activity and that other costs will remain relatively fixed within a wide range of activity. For a flexible budget (also known as a variable cost budget) to operate effectively, the organization must attempt to isolate cost factors according to behavior as the levels of activity change. For example, the number of dietary meals served will vary in proportion to the number of patient days; the dollar amount of food costs (variable costs) for the dietary department will vary based on the meals served within the defined time period. On the other hand, since depreciation on the kitchen equipment is computed on the straight-line basis, the depreciation cost for the time period will be the same (fixed) regardless of the number of meals served by the dietary department.

In between these two extremes are many types of costs that are not so neatly defined. These costs are a mixture of variable and fixed elements and may change with different levels of activity, but not necessarily in proportion to the change in that activity.

In preparing a flexible budget, some estimate must be made of the variability of the different cost factors that enter into the budget-making process. The flexible cost portion of the budget will be represented as a constant dollar amount per unit of output, with the total amount dependent on the actual level of activity. The fixed cost portion of the budget will be fixed in total amount for the time period when related to the relevant range of activities.

The flexible budget is management's most effective tool in controlling costs, once the fiscal year is underway. This flexibility presupposes a list of realistic standards that can be used to measure activity. The flexible budget requires fairly elaborate data collection and processing procedures.

The Department recommends that all hospitals should strive to use the flexible budgeting method for operations to the maximum extent feasible.

Components Of a Budget

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The total budget program consists of the operating budget, the capital budget, and the cash flow budget.

Operating Budget

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In general, the term operating budget will be used to designate five separate parts of the overall plan: (a) the statistical (units of service) budget, (b) the expense budget, (c) reclassifications and cost allocation (d) prospective rate setting, and (e) the revenue budget.

The operating budget consists of estimates of revenues and expenses and their anticipated results for a given period. Estimated future requirements and expenses for personnel, supplies and other items are collected for all departments or areas of responsibility. It also includes estimates of units of service. After determining budgeted expenses and units of measure, the expenses are reclassified and allocated by the cost finding process to determine total operating expenses of each revenue producing department. Revenue requirements for daily hospital and ancillary services are then determined for the preparation of the revenue budget. The combination of estimated revenues and expenses and their results for a given period determines the operating budget.

Capital Budget

4032

A capital budget consists of estimates of the costs for replacements, improvements, and additions to fixed assets that are expected to be acquired during the budget period along with a determination of the sources of funds. The cost of the estimated fixed asset requirements, together with the anticipated dates of acquisition, should be accumulated in an organized manner for each department or area of responsibility. By combining individual capital budget requests, information regarding anticipated acquisitions, priorities, and timing, as well as the feasibility of acquisition, is provided within the capital budget.

Cash Flow Budget

4033

A cash flow budget is an estimate of cash requirements. It consists of the beginning balance, estimates of receipts and disbursements and the estimated ending balance for a given period. The cash flow budget should be prepared by estimating cash receipts from patients and other sources, and applying them against the cash disbursements required to meet obligations as they come due. The cash required for operations, fixed assets, and long- term debt should be determined separately and combined in a summary to reflect the overall requirements. This budget is not required by the Department, but is essential for hospital management to insure that the required cash flow is available during the budget period.

The Process

4100

The total budget process consists of three major budgets: (l) the operating budget which consists of five separate parts--(a) estimates of the volume and mix of activities expressed in terms of statistical measures and other work units, (b) estimates of expenses, (c)

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reclassifications and cost allocation, (d) determination of prospective rates, (e) estimates of revenues; (2) the capital budget, and (3) the cash flow budget.

Departmental Functions

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All departments of the hospital must share the responsibility for their performance under the budget, and must be involved in the preparation of the budget. The departmental involvement in the budgeting process should include the following functions:

- Establishment of operational goals and policies for the department;
- Translation of these goals into management objectives for the department;
- Development of historical, statistical, and financial data for the department;
- Preparation of the required budget forms;
- Testing the financial feasibility of the departmental budget and demonstrating the results of other patient load possibilities and financial alternatives;
- Approval of the final departmental budget; and
- Periodic performance reporting by the department of "earned" budget and actual expenses incurred.

The budget director or controller should coordinate the departmental budget preparation and develop the master budget for review and evaluation by the governing board.

Key Personnel in Budgeting

4120

The key individuals and groups that play important roles in the organization, review and approval of the budget program are outlined below.

Governing Board

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The key function of the governing board is to establish goals and policies and to give final approval to the budget. From this point of view, the budget is a planning document, and to the extent that it encompasses the overall affairs of the hospital, it is properly subject to governing board approval. It is essential that the governing board give tangible support to the budget process.

Administrator

4122

The ultimate line responsibility for the budget formulation and execution is vested in the administrator (chief executive officer). The administrator develops the overall budget goals and objectives within the policy guidelines established by the governing board. In addition, the budget is utilized in evaluating the performance of the departments. Of

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necessity, a large part of the development and administration of the budget program is delegated to subordinate management personnel in the larger hospitals.

Department Heads 4123

The department head, the person to be controlled, should have a voice in developing the budget to be used as an evaluation tool. Unless the department head agrees to the reasonableness of the departmental budget, the control of operations by the budget will be ineffective. Obviously, then, a principal function of the department head is to develop a budget for his own area of operations, as previously discussed, within the framework of broad policies and plans set forth by higher authority. In addition, the department head has the administrative responsibility for budget performance--that is, securing results in accordance with the budget plans--which promotes cost consciousness throughout the hospital.

Budget Director Or Controller 4124

Generally, the controller (chief financial officer) is the logical choice for budget director. The function of the budget director should be to develop procedural details, departmental forms and schedules; provide past statistical and cost data for operating personnel; coordinate the review and revision of budget estimates; and develop the final documents for submission to the governing board.

The budget director must also develop periodic budget performance reports and variance analyses for hospital management. The significant point requiring emphasis is that the budget is made and enforced by the line organization, not the controller. The controller performs the staff function of providing assistance in the technical aspects of budget preparation and reporting.

Budget Committee 4125

Depending on the size of the hospital, there may be a more or less formalized committee assisting in the budget preparation and review process. As a general rule, this committee may be defined as a budget committee chaired by the controller. For example, the budget committee might be composed of the administrator, the controller, and one or more department heads. Representatives of the medical staff and the governing board should serve in an advisory capacity.

Budget Coordination 4130

Before preparing a budget, all personnel involved in budget preparation should meet to discuss the factors that affect the volume of activity anticipated in the budget period. At such meetings, policies and recent changes in policy should be discussed, and planned

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expansion or changes in facilities or services should be brought to the attention of all concerned. Representatives from the medical staff should be asked to discuss any changes in practice and the budgetary implications of these changes. Any facts that will assist in making more accurate forecasts should be discussed. These meetings of the staff will help to develop a better understanding of the hospital's goals and will emphasize the importance of integrated efforts. The budget calendar (timetable) must also be developed to specify the timing of preparation and review of the required reports by all personnel.

After the general policies and facts relative to the services the hospital expects to furnish have been established, statistics and financial data must be analyzed to observe trends. Trends must be related to current expectations in estimating workload units and in developing requirements for personnel and supplies. Since the current fiscal year will not have been completed, the accounting department must compile and summarize the most recent projections of activity to the end of the current fiscal year. The prior year data must also be available to assist in the budget preparation.

The cash flow budget would be compiled by the budget director or controller following the completion of the expense, revenue, and capital budgets. If the cash flow budget, based on estimates contained in the operating and capital budgets, reflects a deficiency in cash balances, adjustments in the other budgets or means of generating cash must be determined by administration.

Budget Calendar (Timetable)

4150

The schedule for the preparation of budget workpapers, including the development of a budget calendar, must be completed early in each year by the controller or budget director and approved by hospital management. Some considerations in preparing a budget calendar are:

- Work should be spread over an adequate amount of time to avoid unnecessary interference with the normal operations of the hospital.
- Adequate time should also be allowed for review and revision of the budget.

Because a number of accounting personnel would probably be involved in various aspects of the budget preparation, the budget should be started early and completed well ahead of the reporting date to the governing board.

Operating Budget

4151

Prior Year: This data can be completed subsequent to year end before preparing the year-end report to the Department.

Current Year: The current years' data includes two periods--six or more months completed to date (actual data) plus projected data for the remaining months of the current year. Since the current year should include a minimum of six months' actual data, the current year's data

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may be completed after the preparation of the financial reports for the first six months of the current year.

Budget Year: This data should be prepared subsequent to the completion of the prior and current years' data.

Capital Budget 4152

This budget presents no particular planning problems since it is initially prepared by the department heads, along with the departmental expense estimates. Time must be allowed to review the requests and to either approve or reject the items requested, and to incorporate capital needs into the rate evaluation and final operations budget determinations.

Cash Flow Budget 4153

Very little planning can be done with the cash flow budget until the operating and capital budgets are completed. The work in determining time lags in cash receipts, however, can be done at an earlier time.

Hospital Goals and Objectives 4200

- Generally, the overall goals of a hospital will be:
- To provide high quality patient services to fulfill the needs of the community, and

To deliver these health care services at reasonable rates in an efficient manner through good management of facilities and other resources.

These goals, by their nature, are conflicting. This conflict provides the underlying rationale for a budget and prospective rate setting procedure. Only through effective planning can a balanced relationship between services and costs of services begin to be achieved.

The governing board defines the overall objectives of the hospital's long-range plan, relates them to the area's needs, and identifies a long-range timetable for implementation. It attests to the plan's financial and overall feasibility. It sees that the plan is updated and that the institution remains viable and on course. In order to do this, the board periodically (or at least annually) evaluates the progress of the institution toward the attainment of its objectives.

To assist the board, it is necessary that hospital management and department heads develop objectives for at least the coming year. The objectives must be segments of the hospital's overall goals and objectives. Hospital management must also develop plans and measure performance of those persons reporting to them.

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The hospital's objectives are achieved by people, not by the hospital. In order to accomplish the objectives of the hospital in an effective manner, the departments must be organized and staffed to perform selected functions. In order to achieve the hospital's objectives, each department must meet its objectives by effective coordination of personnel, equipment, and other resources.

Setting Objectives

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Setting of annual objectives is a critical element in assuring the long-term success of budgeting as a management tool. Criteria for an effective statement of objectives are generally recognized to be as follows:

Measurability: The objective should be stated in a way that the degree to which it is being attained can be measured.

Understandability: The objective should be stated in a way that is fully understood by those responsible for its attainment.

Achievability: Attainment of the objective should be feasible within the constraints given.

Constraints: Constraints are critical to setting and achieving the objectives. Constraints arise from limited resources and conflicts. Both should be reflected in the plan of action.

Organization And Expression of Objectives

4220

All objectives must be in written form to provide an easy reference for all personnel. Objectives may be organized into the following areas of concern:

- Patient care program services
- Management effectiveness
- Training and development
- Communication and community relations
- Quality control and improvement
- Medical education and research programs
- Staffing

Once the governing board has identified the hospital's long-range goals in these areas, they must specify the time frame for accomplishment of the objectives each year. The long-range plan should span a minimum of three years. It should be quite specific and comprehensive, particularly in regard to changes in patient care programs, services and major capital asset needs.

All hospital management personnel should be aware of the hospital's entire long-range plan and each year's objectives. This will assist in developing departmental objectives which will be related to the overall institution and avoid conflicting activities.

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Some hospitals may prefer to identify departmental objectives for several years, rather than just for the budget year.

The determination of objectives must be a joint effort of the department head and the appropriate administrative executive. This is particularly true when setting the departmental staffing objectives. Input from clinical chiefs should also be considered before setting the staffing objectives in patient care departments.

Financial planning (budgeting) contributes significantly to the accomplishment of most objectives. It provides management with the means to make critical decisions. Only with a well conceived budget is it possible to foresee the results of proposed operating alternatives with some degree of confidence; thus, testing the feasibility of objectives greatly increases the chances of the objectives being attained.

The departmental objectives must be completed, analyzed, and revised, if necessary, prior to beginning preparation of the operating budget.