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 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?
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.
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.
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 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.
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:

\[
A/R = ADS \times ACP \\
= $2,000 \times 20 = $40,000.
\]
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?
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.
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.
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
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 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 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?
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)**

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

**Payables level with discount**

Payables = $8,167 x 10 = $81,670.

**Payables level without discount**

Payables = $8,167 x 30 = $245,010.

**Credit breakdown**

Total trade credit = $245,010
Free trade credit = 81,670
Costly trade credit = $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

\[
\text{Cost} = \frac{\text{Discount \%}}{1 - \text{Discount \%}} \times \frac{360}{\text{Days taken} - \text{Discount period}}
\]

\[
= \frac{2}{98} \times \frac{360}{30 - 10} = 0.0204 \times 18
\]

\[
= 0.367 = 36.7\%.
\]
Effective Annual Rate

Periodic rate = \( \frac{2}{98} = 0.0204 \).

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

\[
\text{EAR} = (1 + \text{Periodic rate})^M - 1.0
\]

\[
= (1.0204)^{18} - 1.0 = 0.438 = 43.8\%.
\]
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.
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?
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.
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.
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?