Managing Finance in Health and Social Care

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As Peter Drucker, the great management guru said, perhaps the most important responsibility of a leader is to make sound decisions.[1] Finances and financial management are a crucial part of effective decision-making in a health and social care organization. It is not enough to have good people who are doing an excellent job. The company also needs to be profitable and sustainable financially. To explain it in economic terms, the most important job of a company is to create value for customers. However, it also needs to capture a part of the value it creates to be able to operate in the long run.[2] I believe this is the core of every financial decision. Managers have to determine how to create and capture value at the same time.

A similar idea is explained in Clayton Christensen's famous book[3], *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail*. He refers to it as the "theory of resource dependence"[4]. He says, in many companies executives and managers think they can determine what a company can or cannot do. But in reality, the business as a whole is entirely dependent on customers and investors. Companies that don't satisfy the needs of their customers will fail. So, the ultimate decision-makers in a company are in reality its customers.

We as financial managers can make three different types of decisions. The first one is capital budgeting that determines what long-term investments or projects should the business take on. Capital budgeting is one of the most important financial decisions a manager can make. As Clayton Christensen would say resource allocation and innovation are the two sides of the same coin[5]. Resource allocation is the process that determines what projects and initiatives will be founded in a company. Thereby it determines the companies' ability to innovate. The second type of important decision a financial manager should make is determining how the capital will be spent. How and when should the company pay for its assets? What kind of capital should the company use, debt or equity? The third type of important decision is capital management.

It is about the day-to-day finances of the firm. I will discuss below a few scenarios and important points that a financial manager should pay attention to.

Financial managers can get an accurate overall picture of the firm's financial health by taking a closer look at three important financial statements of the company: the Balance Sheet, the Income Statement, and the Cash-flow Statement.

The Balance Sheet is a snapshot of a business's assets and liabilities at a given point in time (Assets = Liabilities + Shareholders' equity). The five most common parts of a balance sheet are Current Assets, Non-current Assets, Current Liabilities, Non-current Liabilities, Shareholders' Equity. The Current Assets section of a balance sheet shows the assets that are expected to be either used or sold within the next 12 months (of course, if we are talking about a yearly Balance Sheet). Important details to watch are cash and cash equivalents (the money immediately available for use), Accounts receivable (money owed by customers that you can collect), inventory (all the goods available for immediate sale), prepaid expenses, and other current assets (goods and services that have been paid for but not yet used). If we take a closer look at the Non-current assets section we can find assets that are not expected to be used or sold. These are future investments of the company that the company does not intend to get rid of within the next 12 months, for example, property, machinery, and equipment. The next section is Current Liabilities, obligations that the company has to fulfill within 12 months. For example, accounts payable (money owes suppliers), deferred revenue (pre-payments collected from customers for a product that you will deliver them in the future, this will become an obligation for the company), current portion of debt, and finance leases (long term debt that has to be paid this year). The next section is Non-current Liabilities, liabilities that the firm doesn't expect to pay within the next 12 months. Examples include debt and finance leases, net of a current portion (long-term debt of the company), deferred revenue, net current proportion (money received but the good or service has not yet been delivered). The next section is Shareholders' Equity (that we get by subtracting total current liabilities from assets) if we would pay off all the liabilities from assets we have.

The next financial statement every financial manager has to consider is the Income Statement. It shows the earnings and expenses of the company over a specific period and helps to see the companies financial performance. The Gross profit section shows the total revenue minus the cost of generating that revenue. The Operating expenses include all the costs that are not directly associated with delivering the products or services of the company. These are "background processes" that are necessary for the healthy operation of the firm. For example, it includes rent, salaries for executives, other management expenses, selling, general and

administrative expenses, research and development efforts. The next section to watch is the Income (loss) before taxes. It shows any interest paid or received, the income or loss before taxes. The next section is Income or loss after taxes that includes all the income or loss after paying all the taxes.

The third important financial statement of a company is the Cash Flow Statement. Every company needs cash to survive. The cash flow statement gives us information about the firm's liquidity and solvency (having enough funds or liquid assets to make necessary debt payments and fund the company operations). One of the main reasons businesses are failing today is running out of cash and being insolvent[6]. Financial managers have to take a look at the following sections of a cash flow statement: Cash from operations: cash flow from current assets and current liabilities (these include the firm's main revenue-producing activities). Cash flow from investing activities (acquiring or ret rid of long-term assets, like property, machinery). Cash flow from financing activities includes cash coming in or going out due to any equity capital or borrowing.

Having accurate, detailed, and reliable information about these details to be able to make sound decisions that affect the firm's financial health. It is an absolute requirement of making good quality decisions.[7] Using these three financial statements managers and executives can have the necessary information to make good decisions.

Managers also need to pay attention to the balance between short-term and long-term sustainability[8] [9]. Managers and executives often tend to optimize short-term performance without considering the long-term financial health of the company. This is party due to a cognitive bias (identified by the Nobel-prize-winning psychologist Daniel Kahneman), called "discounting the future"[10].

The following ratios were calculated to present the firm’s financial situation to the board of directors. These ratios have special importance in terms of short- and long-term decision-making.

DESCRIPTION	2016	2017
Current Ratio	1.5	2.28571
Quick Ratio	1	1.57142
Total Asset Turnover	1.7666	1.5357
Profit Margin	0.0339	0.0395

Receivable Turnover Ratio	26.5	28.6666
Return on Assets	0.06	0.0607
Return on Equity	0.1125	0.1789

When analyzing financial statements a useful approach is to pay particular attention to things that can go wrong. If we have a risk-based approach in pace for analyzing financial statements we can ensure the firm's sustainability much better.

As a first step, we can take a look at the firm's short-term situation before considering longer-term issues and opportunities. By looking at all the obligations a company has and comparing it with the available amount of cash. The question is: do we have enough cash to cover all the current liabilities? If not, where does the money come from? A very useful guide could be to look at the short and long-term solvency ratios, such as current ratio, quick ratio, and especially cash ratio. The point is to make sure that the firm has significant liquidity at any given time to cover its liabilities. I illustrate the point with the following example. The Current Ratio (calculated by dividing current assets with current liabilities) tells us a great deal about the firm's short-term survival chances. It is the ability to meet short-term obligations using the firm's current assets. It needs to be higher than 1 to indicate that the company has enough funding to meet short-term obligations. In 2016 the current ratio was 1.5 and in 2017 it was 2.28571, which indicates that the company can meet its short-term obligations. Another good indicator of the firm's short-term survival chances is the quick ratio. It indicates if the company has enough quickly available assets to cover its short-term obligations. It also needs to be higher than 1. In this case, the ratio in 2016 is 1 and in 2017 is 1.57142. Overall, the firm is not in immediate danger, it can meet its short-term obligations.

Perhaps the second most important thing to start with is to look at the profitability of the company. The biggest question when we look at the profitability of a company is: do we generate enough profit, so we can make sure we're not running out of cash? A useful place to start is the income statement. If we compare the amount we generate by selling our products or services (Sales) with the Net income it will tell us how much the firm can capture from the value it creates. The firm's profit margin in 2016 was 0.0339 and in 2017 it was 0.0395. As a healthcare company, this profit margin is quite healthy, however, we can get a more accurate picture if we compare it with other firms from the same industry and sector.

The third thing I would pay attention to is the effectiveness and efficiency of the company. For example, we can get a good overall picture by taking a closer look at the asset turnover ratio. It measures the efficiency of the firm's assets in generating revenue. If the company waists its resources by not utilizing them in the most efficient way the ratio will be lower than one. In this case, in 2016 the ratio was 1.7666 and in 2017 it was 1.5357, which indicates the firm is working efficiently. Return on assets (ROA) is another indicator of the firm's overall efficiency. It shows us how efficiently the firm's management using its assets to generate profit. The 0.06 ROA measured in 2016 and the 0.0607 ROA measured in 2017 tells us the company is could've been managed more efficiently. From a healthcare company, these values are a little too low. However, we can get a more accurate picture if we compare these values with the ROAs of other firms within the same industry. Another great ratio that also tells a lot about the firm's efficiency is the return on equity. It measures how efficient a company is at generating profits from the initial amount of money the firm got from shareholders. Firms with a high return on equity can be very attractive to investors because it tells that the company is efficient in generating profits. In our case, in 2016 the company had a 0.1125 return on equity ratio and in 2017 the ratio was 0.1789.

There are a few powerful financial tools to help decision-making in the health and social care organization. Three approaches could be especially useful: determining operating and cash cycles, determining which financial policy is the best fit for the firm's current situation, and making a short-term financial plan. I will explain these measures in detail below.

In today's fast-changing business environment perhaps one of the greatest challenges is to stay agile and flexible enough to not just react to changes but actually grab great opportunities[11]. In financial terms, it means having enough free cash on hand to meet the firm's short-term obligations and being able to finance unanticipated opportunities. For example, if it takes 30 days on average to collect the money from customers after a sale and it takes 60 days to sell the firm's entire inventory the operating cycle of the firm will be 90 days.

If we want to calculate a firm's cash conversion cycle we have to start with the firm's operating cycle and divide it with days payable outstanding. In other words, we take the number of days it takes for the company to sell its inventory + the number of days it needs to actually collect the money from customers, divided by the number of days the company needs to pay its suppliers. Calculating the operating and cash conversion cycle and comparing them to each other gives us an understanding of the financial dangers a firm might face. The bigger is the

gap between the operating and cash cycles the longer a company has to finance itself until it can get the money from customers they need. If financial managers don't find a way to pay their suppliers before receiving the money from customers the company will be in short-term financial danger.

Financial managers of a company often have to deal with short-term financial problems. More often than not behind these problems the underlying cause is short-term liquidity problems when the company has to pay its account payable faster than it can get money from its accounts receivable. If their operating cycle is significantly longer than the cash cycle managers have a few options on how to generate enough cash in other to stay liquid enough. However, every option has its benefits and tradeoffs. By obtaining financing managers might increase the long-term debt, equity, or current liabilities of the company. Choosing another path, by selling assets to generate cash managers decrease current and fixed assets of the company. Most often these decisions are difficult to make because there are many interrelated and interconnected sub-systems that every change can affect. Moreover, many of these decisions - especially if we work with a large corporation - involve many different financial managers with different titles, duties, and responsibilities. For example, cash manager, credit manager, marketing manager, purchasing manager, production manager, payables manager, accountant are responsible for many different but interrelated tasks.

By choosing a short-term financial policy appropriate for the current situation of the company we can make sure we can align the many small decisions financial managers will make. There are certain times when the asset and inventory requirement of the company fluctuates. It can be the consequence of many factors, like seasonality, changes in customers' taste, demand fluctuation. Based on these fluctuations managers can follow two different kinds of short-term financial policies. One is called "Flexible" financial policy, when we make sure the financing of the company includes all the assets a company needs at every given point of time. In this case, the company doesn't have to borrow money from external or internal sources. However, it won't be as efficient if we would use just as little amount of money as possible to build a kind of financial "safety net". However, we can take another approach as well. We can make sure the firm’s financing only covers the minimum amount of total assets a company needs. From time to time we will fall short on cash, so the company needs to borrow money to make sure we can meet all our obligations. The question is the following: what is the better approach?

There is no standardized answer to what policy is better, everything depends on the particular situation the company is in. For example, it can depend on the cost of raising capital.

If it is very inexpensive to raise money for longer terms maybe it is better to use a flexible policy. If borrowing money is relatively expensive we may follow a restrictive financial policy. However, it can be dangerous if we are not able to borrow the required amount of money as quickly as the firm needs it. Financial managers can apply only one policy from the two or they may use a combined approach, when the company has reserves in times of need, like anticipated demand spikes, but not keeping as much money on hand to compromise efficiency.

There are a few other tools as well to make sure we make the best financial decision. For example, developing an using an economically based resource allocation process could be a real game changer[12]. Most companies are relying heavily on executives as the only people who make high-stake decisions. The hard truth is that in many cases one person or just a small group of people could not make such good decisions as we usually think. Many scholars call this the "HiPPO" method[13], when in decision situations the most relevant factor is the Highest Paid Person's Opinion. People are inherently full of biases that can hugely affect decision-making. Even when we, as financial managers work with numbers, biases can affect our decision-making processes when we select, interpret and contextualize those numbers[14] [1516]. Nobel-prize-winning psychologist, Daniel Kahneman[17] showed us how great we can overestimate our ability to make sound decisions. Decision-making and forecasting expert Philip E. Tetlock[18] and Nobel-laureate economist, Paul Krugman[19] goes even one step further. They argue, even experts are wrong most of the time and even knowledge and expertise acquired throughout a lifetime cannot guarantee good decisions. In his insightful book, Alistair Croll and Benjamin Yoskovitz[20] recommend using an economically based decision-making process when we make financial decisions. They recommend comparing the "opportunity cost" of all available options and then choosing the one with the highest overall return. It is also very important to use a sound decision-making process, especially when making high-stakes financial decisions. A possible useful approach could be to implement the “Decision Quality” decision-making framework[21], pioneered by Stanford University professor Carl Spetzler. (It is based on the “Decision Analysis” theory developed by Peter McNamee, John Celona.[22]) Following the 6-step approach of Decision Quality, we can make high-quality financial decisions in face of uncertainty.

As we have seen financially managing a company can be a complex challenge that requires the coordinated work of many people, systems, managers, customers, and institutions. Making actual high-stake financial decisions can be an even harder job. That's why we need to be familiar with the three basic financial statements of the company and have to have a collection of financial tools and practices. Financial managers also need to be good decision-

makers. In my opinion, the third most important thing for a financial manager is to be a "people person" as well[23]. When managers are working just with papers and numbers all day long it is easy to forget there is a person behind every number. Therefore financial managers have to have a deep understanding of the decisions they make based on those numbers and their real-world consequences as well. This way we can build and manage an effective healthcare organization.

Endnotes

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