FAQ: Budgeting and Health Care Industry

Question 1: How does budgeting relate to the health care industry?

Answer: The budget is the heart of a company’s financial plan. It is truly an instrument that places monetary value on business activities (Baker & Baker, 2006). To help understand budgeting as it relates to the health care industry, the American Hospital Association (as cited in Baker & Baker, 2006) has put together four objectives that outline the budgeting process. They are as follows:

- To provide a written expression, in quantitative terms, of a hospital’s policies and plans
- To provide a basis for the evaluation of financial performance in accordance with a hospital's policies and plans
- To provide a useful tool for the control of costs
- To create cost awareness throughout the organization

Question 2: What kind of budgets are there?

Answer: With these four objectives in mind, examine the common types of budgets: static and flexible. A static budget is based on a single level of operations. Once official, it is not adjusted, thus earning the name of static. A flexible budget is a range of activity that is adjusted to the actual expected output achieved. This type of budget varies to the activity during the particular budgeting period.

Question 3: What is the variance of budget?

Answer: Regardless of the type of budget, the most important factor is the variance of the budget. The variance is the difference between the actual results and the budgeted result. When calculating the variance of a static budget, the static budget variance is the actual results less the static budget amount. Variance analysis for a flexible budget is a bit more complex. It can involve volume variance, quantity variance, and price variance.

Question 4: What is a flexible budget?

Answer: Flexible budgets in regard to health care are important because of diagnosis-related groups (DRGs). When DRGs came into effect for hospitals, flexible budgets became increasingly useful (Baker & Baker, 2006). Flexible budgets should address the areas of workload, control, and planning.
Although flexible budgets are not as routine as static budgets, they are essential to financial management.

**Question 5:** What is a capital expenditure budget?

**Answer:** After examining budget types, it is important to address capital expenditure budgets. These are budgets surrounding the acquisition of assets to the company (Baker & Baker, 2006). Common capital expenditures include the purchasing of land, buildings, and even equipment. These budgets surround the issues of long-term finances. Another common name for a capital expenditure budget is capital spending plan (Baker & Baker, 2006). The first part of the capital expenditure budget should be about the assets already existing. This is spending that helps maintain the current assets. The second part of this type of budget is about the acquisition of new capital assets.

**Question 6:** How is cash flow reported in a capital expenditure budget?

**Answer:** Some important aspects to remember regarding a capital expenditure budget is how cash flow will be reported, how funding requests will be made, and how capital expenditure proposals will be handled. There are the following four methods of reporting cash flow (Baker & Baker, 2006):

- Payback method (based on cash flow)
- Accounting rate of return (based on profitability)
- Net present value (based on incoming and outgoing cash over the lifetime of the item)
- Internal rate of return (similar to net present value, accounts for incoming and outgoing cash over the lifetime of the item and profitability)

When evaluating capital expenditure funding requests and proposals, it is important to evaluate the necessity of the item, the cost to the organization, and the return on investment.

**Reference**