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DEPRECIATION, LEGITIMATE HOSPITAL EXPENSE

By ELIZABETH S. RODKEY, C.P.A., Baltimore Chapter ASWA

In days gone by, the majority of our hospitals failed to record depreciation, ignoring it completely as an item of expense. Very few hospitals even kept records of the original cost of the hospital plant and equipment. Today, hospital accountants, consultants, administrators and trustees are being converted to the school of thought that depreciation is a legitimate expense of hospitals and, therefore, should be recorded.

Why was depreciation ignored in the past as an item of hospital expense? Originally, the fixed or capital assets of hospitals were donated by public-spirited citizens or philanthropic organizations. These donors were not concerned with recovery of their gifts. The general theory of the hospital accountants was that these assets did not represent an actual expense of the period during which the plant and equipment were utilized because they had been donated to begin with and would be replaced with further donations. It may also be pointed out that hospital trustees did not know what constituted operating expenses. It was thought that charges to patients could not be geared to these costs and therefore could not be collected from the patient.

On the other hand, accountants treated short-term equipment such as hospital beds as an item of expense to be charged against income during the period of purchase. Apparently no necessity to show a realistic matching of costs with revenues during the period such equipment was in use was recognized by hospital accountants.

Whatever the origin of the failure of hospitals to treat depreciation as an expense, the problem of whether or not depreciation should be treated as an expense is the subject of much controversy among accountants, more particularly municipal and hospital accountants.

Those who believe that depreciation charges are out of place in hospital accounting rely on several arguments. All appear to stem from the differences between commercial and charitable or social institutions. Thus we are told:

> . . . the purpose of depreciation accounting in private business is to distribute the cost of the assets over their useful life, toward the end of arriving at a more nearly accurate net profit, especially for the purpose of restricting the amount of dividends. These needs are not present in institutions which do not operate for profit. . . .
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> . . . The purpose of a commercial enterprise is to produce income. Therefore, depreciation is applied to fixed assets properly to compute the income produced, and to allocate to income all costs of producing it. There is a direct relationship between income and the fixed assets used to produce that income. In social enterprises, on the other hand, the purpose is to serve the community, not to produce income. There is, therefore, no such direct relationship.
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> A commercial enterprise must pay all of its costs from income of its activities. This is not true of a social enterprise. Support of the latter in this country is a 'joint venture.' The patient (in the case of a hospital) bears part of the cost through direct payment; the people bear part through their government by making appropriations for capital costs and by exempting the enterprise from direct taxes on income, property, and gifts received; and society as a whole bears part through direct gifts. Past generations contribute to present support through endowment funds, while the present generation supports the enterprise through gifts of money and gifts in kind.
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> Since depreciation represents the recovery of an expenditure, and since expenditures for plant assets usually are not made by governmental or other non-profit agencies out of funds contributed by them, but out of funds appropriated to or given them by others who are not concerned about recovery, the problem and treatment [illegible] in such enterprises are different from those in privately owned and profit seeking enterprises generally. As it is not the purpose or intent of hospitals to yield a profit, a device used for profit computation, the customary depreciation charge, seems out of place in this type of organization.[1]

The intent of the writer of the quoted passages is to "(1) review the place and function of accounting for and reporting depreciation on plant assets in public and endowed hospitals (as distinct from proprietary) and (2) to question the methods for such accounting proposed by a committee of the American Hospital Association."[2]

Other accountants do not agree that these arguments are sufficient reason to neglect depreciation as a legitimate hospital expense. Originally it is true, hospitals were not concerned with earning sufficient income to purchase or replace fixed assets and the more expensive types of short-term equipment. Today, however, our hospitals do not receive the large endowments, grants and donations that they once did. In the past few years remarkable strides have been made in medicine. The type of equipment used must keep pace with new discoveries in medicine. Such equipment has doubled and tripled in cost of manufacture and retail price. In all probability, future fixed assets and expensive short-term assets will have to be purchased from earned hospital funds rather than from donations of private individuals or groups.

The progress of depreciation accounting in hospitals is extremely varied. Some of our hospitals have set up a fixed asset or plant ledger in recent years. Some have maintained a record of equipment purchased, but have overlooked the recording of donated equipment. Others have established a ledger or register for record purposes only. Varying rates of depreciation are in use by different hospitals. Some use the rates of depreciation as established by the American Hospital Association. Still others have set up their own rates, established a composite rate or even used the production method of depreciation.

Although hospital administrators and accountants are not interested in making a profit in the sense of private business, they are vitally interested in operating on a break-even basis that permits them to continue to operate. For hospitals to operate on a break-even basis, depreciation must be included in the costs of hospital operation in order to allocate them to the patient or his insuring agent. Depreciation is properly included in the costs used for these contracts with outside agencies. The contracting agencies usually pay on a business basis, that is, including an allowance for depreciation of plant and equipment. Unless a record of depreciation is set up, these agencies may object to depreciation expense for reimbursable costs. Lloyd Morey [3] points out that depreciation does have a usefulness for rate making purposes.

Coates, replying to Lloyd Morey, says, "It seems quite clear to me that hospitals must have buildings in which to operate and must have equipment that, to a material extent, is charged for in the hospital rates, which constitute its revenue. I do not feel that hospital accounting that did not account for all the elements of costs would be of major use as a management tool, and I am sure that its effectiveness would be impaired if it recorded only financial transactions insofar as they relate to the inward and outward flow of money or cash equivalent." [4]

Both Mr. Coates and Mr. Morey appear to be in fundamental agreement on the question of the desirability of funding depreciation provisions.

There is another relationship, however, in which depreciation is important where a charge against the current income in relation to the property used is important; that is in connection with replacement. The mere bookkeeping process of depreciation does not result in the accumulation of funds for replacement. This is not accomplished unless funds are actually reserved for that purpose.

These facts appear to have had only passing consideration by the committee and by other writers, yet they are fundamental in their nature. Hospital facilities do require not only maintenance but eventual replacement. A hospital may well seek sufficient revenue so that from it there can be provided the eventual replacement of its equipment and even its buildings, partially or fully. Provision for depreciation to cover such needs would be appropriate. However, that can only be accomplished when cash from income is actually set aside for such replacements.[5]

Mr. Coates points out, "the purpose of providing depreciation in hospitals is in recognition of the fact that buildings and equipment lose value as they are used, and the funding of such depreciation provisions is desirable to perpetuate the hospital."[6]

As John Berberich says, "The problem of financing hospitals in these days of increasing costs and decreasing endowments is a stupendous one. The community looks to its hospital trustees and to the administrator, as chief executive of the hospital, to provide adequate income and to control expense so that its hospital will continue to serve the community efficiently as well as economically."[7]

The American Hospital Association in its handbook on Hospital Accounting states, "Depreciation of hospital buildings and equipment should be recognized as an element of hospital expense. The depreciation in value of buildings and equipment represents a real cost of hospital service,

even though such assets may have been contributed originally to the hospital and even though no cash or other funds are set aside to replace such assets."[8]

There are hospitals which have advanced to the point of departmentalizing depreciation expense as well as the regular operating expenses. This is very useful for cost and statistical purposes to determine the cost of an X-ray or a laboratory test. By distributing the non-service department costs to the service departments based on in-patient, ambulatory patient, and out-patient, costs per patient can be determined. These are valuable aids in determining whether rates should be increased in those revenue-producing departments low in income. Consistency in summarizing and recording data is important as it aids in making comparisons between years and to take such steps as necessary to improve the operating efficiency and income of low revenue-producing departments.

"Good financial records," says Rubenstein and Fabisak, "are becoming more and more significant in hospital administration. Many of the current financial problems have resulted from the wide variance in the accounting methods among hospitals. The lack of uniform statistical definitions, record keeping, cost distributions, and rate setting have brought considerable confusion in dealings with governmental agencies, Blue Cross and other third parties purchasing hospital care."[9]

Because of the increasing use of hospital facilities by agencies which should pay the full cost of services rendered and the uncertainty of the financial ability of future generations to provide fixed or capital assets, hospital accountants, consultants, administrators and trustees are being converted to the school of thought that depreciation is an expense of hospitals and, therefore, should be recorded.

REFERENCES

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Social Security Numbers—

All wage items are reported under Social Security numbers. Our records are kept in a central file in Baltimore, Maryland. We have issued over ninety million numbers. We receive some sixty-five million wage items a quarter. The Social Security number is most important. If there is no number or a wrong one it starts costing us money and makes much trouble for you.

Original numbers are issued at once by us.

Duplicate numbers can be issued at once if a stub is presented. Otherwise it takes ten days, as we must screen the application.

You or an employer can always have a supply of forms SS-5 or OAAN-7003.

An employer is contacted personally or by letter in three types of cases.

OAR-1094—Incomplete returns where an account number is missing.

OAR-5031—Where the number or name reported is different on our records (married women).

OAR-5032—Where an employer reports a wrong number on four consecutive returns.

Each employer has an obligation to get the Social Security number. If he cannot, the back side of the return gives instructions for him to attach a completed form SS-5.

Suggestions—

The tax deducted from the employees is sometimes more than 2% of the payroll, due to the fraction of a cent involved in making individual computations. These pennies should be included in the amount sent to Internal Revenue.

Form SS-4 for an employer's identification number may be obtained from one of our offices or from Internal Revenue.

We are glad and happy to be of assistance. Feel free to call upon us at any time.