

CHAPTER

1

Introduction to Financial Management

OBJECTIVES

After completing this chapter, the student should be able to:

1. Discuss the importance of financial management to pharmacists,
2. Explain the goals of financial management and why they are relevant for pharmacies,
3. List and briefly describe the four most common financial statements, and
4. Discuss the limitations of financial management.

Pharmacy practice has changed dramatically over the last several years. Pharmacists are more likely to be employees than owners; to work for large organizations, such as hospitals, chain pharmacies, and managed-care pharmacies, than in small, independently owned pharmacies; and to have clinically oriented, patient care responsibilities rather than purely distributive duties. Although these changes have been associated with a dramatic decline in the number of pharmacists who own their pharmacies, they have not affected the number who are managers. In fact, the need for pharmacy managers has increased. This has occurred because large organizations, such as major hospital pharmacies, managed-care pharmacies, and chain pharmacies, need pharmacist managers for coordination and direction.

The need for pharmacist managers has also increased as technicians and automation have assumed more dispensing functions. Pharmacist managers are needed to supervise technicians and to manage the increased use of dispensing technology. Pharmacists have also found ownership and management opportunities in a variety of new settings. Contemporary pharmacists hold management and ownership positions in home health care and home IV infusion businesses, long-term care consulting organizations, disease management companies, pharmacy benefit managers (PBMs), insurance companies, and pharmaceutical care training companies.

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Managers are responsible for planning, organizing, and controlling resources so that the organizations in which they are employed meet their goals. Many contemporary pharmacists meet this definition of a manager. Owners of independent pharmacies continue to function as managers, as do directors of hospital pharmacies. Chain pharmacies employ pharmacists as pharmacy and store managers, district managers, and directors of professional operations. Large hospitals and managed-care organizations employ pharmacists as clinical coordinators and formulary managers.

The essence of the manager's job is making decisions. Many of these decisions have important financial implications. The purpose of this text is to help pharmacists develop the skills they need to make more effective financial decisions.

Financial management focuses on making wise decisions about obtaining and using financial resources. These resources include both funds that the owners of an organization have invested in it and funds that the organization has borrowed. Pharmacist managers face many such decisions: how much inventory to carry, which sources of supply to use, how to set prices, which third-party prescription plans to participate in, which drugs to include on a formulary, whether a new disease management service will be profitable, whether the hospital should open a pharmacist-managed hypertension clinic. Being familiar with the tools and techniques of financial management will help pharmacists make better decisions when faced with such questions.

GOALS OF FINANCIAL MANAGEMENT

The principal goal of financial management is to increase the value of the organization. A major part of achieving this goal is making efficient use of financial resources. Pharmacies, for example, carry inventories of prescription and nonprescription drugs. They must invest cash, a scarce financial resource, to buy inventories. Pharmacies make the most efficient use of cash that is invested in inventories when they carry the smallest amount of inventory necessary to meet consumer demand. Carrying larger inventories is inefficient because it takes cash away from other, more productive uses.

Making the most efficient use of financial resources is more important than ever before in pharmacy practice. Pharmacies of all types face substantial competition and economic challenges. The community pharmacy market has become increasingly competitive. Ambulatory consumers can obtain their prescription medicines from a number of outlets including pharmacies in supermarkets and mass merchandising stores (such as K-Mart and Wal-Mart), mail-order pharmacies, ambulatory care clinics, and physicians' offices, as well as traditional chain and independent community pharmacies. All of these face financial pressures from the reimbursement policies of government, managed-care, and other third-party prescription programs intent on controlling prescription drug costs. These policies have dramatically decreased the prices and gross margins that pharmacies receive for prescriptions. In the new competitive environment, pharmacies must use financial resources efficiently if they are to survive and grow.

Hospital pharmacies face similar financial pressures. Insurance companies, managed-care organizations, and federal and state governments have instituted a number of programs to control the increases in hospital costs. The federal Prospective Pricing System, for example, mandates that hospitals be paid no more than a fixed and predetermined amount for each inpatient with a given diagnosis. If the hospital spends more than this amount to treat the patient, it must pay for the excess. The federal government has also implemented prospective pricing programs for ambulatory care services provided in hospitals and for long-term care facilities (nursing homes).

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Private insurers and managed-care organizations have implemented similar programs. As a result, hospitals and long-term care facilities must manage resources efficiently or face bankruptcy. The pressure that cost containment efforts have placed on these facilities is passed down to each department—including the pharmacy. To prosper in this environment, pharmacy managers must understand and be able to communicate the financial implications of decisions they make and programs they plan.

Pharmacies of other types—those in health maintenance organizations (HMOs), those providing home IV infusion services, and those providing consulting services to long-term care facilities—face similar pressures to control their costs. To survive and thrive in the cost-conscious health care environment, pharmacist managers must have a thorough understanding of the principles of financial management.

As these examples illustrate, financial management is as necessary and appropriate for nonprofit organizations, such as hospital pharmacies, as for profit-making firms. Both have limited resources and both are under considerable competitive pressures to make the best use of them. Using resources efficiently maximizes the value and effectiveness of both types of organizations. Even in nonprofit organizations, there is no excuse for using funds inefficiently.

ACCOUNTING AND FINANCIAL MANAGEMENT

A proper understanding of the tools and techniques of financial management requires a basic working knowledge of accounting. Accounting is a specialized language used to communicate financial information. This information is communicated via *financial statements*.

Accounting data, and the financial statements developed from them, are maintained because they aid decision making. Financial statements facilitate decision making in three areas. First, financial statements provide information to decision makers. With this information, decision makers can better assess the financial implications of various decisions they must make. For example, bankers are decision makers. Before making loans, they will carefully evaluate the financial statements submitted by applicants to decide whether they can repay the loans. Managers are also decision makers. They use financial statements, for example, to make pricing decisions, to help decide whether to hire additional personnel, to decide whether to buy new equipment, and to decide which services to offer.

Second, financial statements aid decision makers by reporting the results of past decisions. The prudence of a banker's past lending decisions will be reflected in his or her current financial statements. Likewise, a manager who makes poor service and pricing decisions will notice, on financial statements, a decrease in profits.

Finally, financial statements keep track of a range of financial items such as cash, debts, and assets. Decision makers need this information to efficiently and effectively manage their organizations.

Financial statements provide decision makers with the following types of information:

1. Present financial status of the business. The balance sheet, or statement of financial position, indicates what a business owns and what it owes at one point in time.
2. Past profit performance of the business. The income statement, also called the profit and loss statement, indicates whether the business made a profit or suffered a loss over some period of time.

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3. Where the business is getting its *cash* and how it is spending it. This is found on the statement of changes in financial position or the cash flow statement.
4. How the owners' investment in the business has changed over some period of time. This information is found in the statement of capital or the statement of retained earnings.

The income statement, balance sheet, and capital statement are presented and discussed in the next chapter. The cash flow statement is introduced in the next chapter and discussed in more depth in a later chapter.

LIMITATIONS OF FINANCIAL MANAGEMENT

Financial management is a tool that managers can use to better assess the financial implications of decisions they face. Its use should be limited to deciding among potential courses of action that will help the pharmacy to reach its goals. In most cases, it should not be used to decide what those goals are, nor should most decisions be based solely on financial criteria. For example, a hospital pharmacy could decrease its expenses, and maintain its revenues, by switching from unit-dose to multiple-dose drug distribution and by cutting out all clinical and educational services. If the pharmacy's decisions were based solely on financial criteria, a financial analysis might show the advisability of this course of action. But a hospital pharmacy has a higher and more basic mission than to operate as cheaply and profitably as possible. Its primary mission is to provide pharmaceutical services that improve patient care. Unit-dose distribution and clinical and educational services substantially improve patient care. Consequently, the decision of whether to offer them should not be made solely on the basis of financial criteria. On the other hand, given that a pharmacy has limited financial resources, the decision as to which particular clinical and educational services to offer would benefit from a financial analysis.

Financial statements do not contain all the information, or in many cases even the most important information, about the factors that affect the finances of a pharmacy. Such necessary data as the state of the national and local economy, the demand for the organization's product or service, the extent and nature of the competition, and the health and loyalty of key employees are not found in financial statements. This is because financial statements deal only with those events and factors that can be readily expressed in monetary terms. In using and interpreting financial statements properly, managers must keep these limitations in mind.