Chapter 1

Corporate and Partnership Structures in Healthcare

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Learning Objectives

- Discuss the advantages and disadvantages of alternative entity forms.
- Understand the various organizational structures in a healthcare environment.
- Understand equity differences among organizational types.

Chapter Outline

Introduction

You may think accounting is a necessary evil that you must learn, even though it is not your primary professional goal. In reality accounting is critical to any decision maker in the healthcare field. A strong understanding of accounting will help you manage your department or division as you move up the ranks of healthcare institutions.

In this text you will learn how to use accounting strategies, such as managerial and financial accounting, to address healthcare issues from a financial perspective. While accounting is not the only skill you need to manage in a healthcare environment, it is a critical skill for making decisions that will enable you to manage more cost effectively and improve your institution's profit potential. First, let's take a look at how healthcare facilities organize their business.

In today's medical field, few physicians starting out organize as a one-person business called a sole proprietorship. While they do exist, it is more likely they will join a partnership or a major medical organization. That organization could be a for-profit or nonprofit hospital, clinic, medical group practice, emergency care facility, surgery center, or other ambulatory care organization, or maybe some other organization that hires physicians. Many of these organizations operate as for-profit or nonprofit corporations. Some states allow medical groups to form as professional corporations or limited liability companies. In addition, you may find yourself working for a governmental healthcare institution, such as the medical facilities run by the Veterans Administration or community-based hospitals.

Generally, they all follow the same basic accounting rules, but there are two organizations with the responsibility to develop rules in accounting, called **generally accepted accounting principles (GAAP)**. The organization that develops rules for private entities is called the Financial Accounting Standards Board (FASB) (http://www.fasb.org/home), and the one for governmental entities is called the Governmental Accounting Standards Board (GASB) (http://www.gasb.org/). As a non-accountant, you will likely never read a GAAP. These are highly technical documents that specify the rules accountants must follow when collecting accounting data and preparing financial reports. There are technical accounting differences between governmental and nongovernmental organizations, but these are beyond the scope of this course.

Given the risks today of being sued, many doctors, even if they plan to open an individual practice, will seek an organizational structure that will give them some liability protection. While only medical malpractice insurance will cover the doctor for lawsuits involving professional negligence, as a business owner, a limited liability organizational structure can give the doctor protection from personal liability for business debts or legal matters, such as employment discrimination lawsuits.

Partnerships without liability protection are extremely rare in the medical professional because physicians in the group can be held liable for the actions of other physicians in the group. When more than one physician is involved, the medical group is more likely to organize as a limited liability company or professional corporation. The actual structure chosen will differ by state because states do restrict how physician groups can incorporate or seek limited liability protection.

1.1 The Corporation

Let's begin by thinking about the advantages and disadvantages of a corporate structure, whether it is a for-profit, nonprofit, or a governmental entity. A corporation is a legal entity having existence separate and distinct from its stockholders. Corporations exist only in the legal sense and cannot exist unless specific actions are taken.

However, one does not have to form a corporation to conduct business. Business can also be conducted via a sole proprietorship or partnership. As you read on, you will quickly find that one should only use the sole proprietorship or partnership by design, not by accident.

Why would you want to consider forming your business as a corporation? For starters, it permits otherwise unaffiliated persons to join together in mutual ownership of a business. Funds can be accumulated and concentrated into one organization. Significant pooling of resources can occur that might not otherwise be possible. A corporate strategy often might entail a large amount of risk with highly uncertain outcomes. Probably you are willing to risk a small amount of your wealth on speculative investments with the potential for a high payoff, but you are unlikely to bet everything you have. This is often the dilemma faced by new healthcare businesses. Think about the financial investment required to build the medical facility and buy medical equipment and medical supplies. Few physicians can afford to buy everything needed to start a medical practice on their own.

Some ventures are so large that shared ownership is essentially required. Therefore, the stock of the corporation provides a perfect vehicle for mutual ownership of a business. When new doctors are added to a practice, negotiations for ownership can be based on the number of shares awarded as an incentive to join the practice or the number of shares bought to become part of the practice. Each shareholder can invest at a level that matches his or her wealth and risk tolerance attributes. An important aspect of the corporate form of organization is that shareholders are usually only at risk for the amount they invest in the company's stock. Creditors cannot pursue shareholders for additional claims beyond the shareholder investments.

Most corporations allow shareholders to vote in proportion to their shares, with one vote per share. This democratic process allows shareholders to participate in corporate governance based on the level of their investment. Shareholders vote on matters set forth in the bylaws. The voting is usually conducted on a ballot that is termed the *proxy*.

Another advantage of the corporate form of organization is the relative ease with which shares of stock can be transferred to another. Stockholders can normally sell their shares to others or buy more shares without direct involvement by the corporation. Transferability of ownership makes stock a relatively liquid asset to its holder. Further, companies can often access additional capital by issuing more shares to current and new shareholders.

In some cases, a company may go public, meaning that it lists its shares on one of the popular stock exchanges, such as the New York Stock Exchange (NYSE) or the National Association of Securities Dealers Automated Quotation (NASDAQ) system. This is not common for medical practices, but it is common for for-profit hospital organizations. An **initial public offering (IPO)** of shares is an exciting (and costly) decision and is sometimes accompanied by so-called road shows and various other promotions designed to market the offering. Road shows are company-sponsored events where corporate executives present their business case in the hopes of developing interest among potential investors.

A corporation is presumed to have a **perpetual existence**. Changes in stock ownership do not cause operations to cease. The death of a shareholder does not bring about a need to dissolve the company. Instead, the beneficiaries of the estate of the deceased become new owners. A corporation will continue to exist and operate until it is merged in with another, it fails, or a corporate action is undertaken to liquidate the company. When the latter happens, all bills must be paid, and common shareholders are entitled to final distributions of any residual funds in proportion to shares held.

Perhaps one of the most significant advantages of a corporation, especially when compared to partnerships and sole proprietorships, is the feature of **limited liability**. The liability of stockholders is normally limited to the amount of their investment. Stockholders are not personally liable for debts and losses of the company, except to the extent of their investment, or any additional guarantee of corporate debt. However, you should be aware that a corporate entity is not a perfect shield against all liability. If affairs of the shareholders are comingled with the corporation or there is malfeasance by shareholders or officers, a lawsuit may be filed by damaged parties against the shareholder or officer. It is not always possible to avoid these types of claims, but taking care to meet good legal and accounting practices is a good start. This underscores the need for you to be well versed in proper accounting procedures and internal controls in managing your departments.

Corporations also suffer under the weight and cost of added regulatory oversight, especially when the stock is publicly traded. Agencies such as the Securities and Exchange Commission (SEC) impose stringent reporting guidelines, including mandatory and expensive audits. Additional rules require companies to have strong internal controls and ethical training. The financial statements must also be certified by senior officers who do so under the risk of prosecution for perjury. To be sure, if you were an officer being required to sign such documents, you would undoubtedly expend ample funds to ensure that the statements were reliable. Suffice it to say, the cumulative cost of meeting regulatory stipulations is high.

Nonprofit Corporations

In addition to for-profit corporations, healthcare organizations also organize as nonprofit corporations. Generally, the accounting for these organizations is similar, except for profit distribution. Nonprofits do not distribute profits, but instead the profits are kept for future use by the institution. Often these organizations grow by raising funds from donations and grants. The equity (or ownership) portion of the nonprofit differs significantly. Rather than its equity being stated in shares of stock, the equity is tracked by asset classes:

1. Unrestricted: resources with no restrictions on how they can be used.
2. Temporarily restricted: resources that must be used for a particular purpose at some point in the future. Once the terms are met, the assets can become unrestricted.
3. Permanently restricted: resources that must be used for the stated purpose in perpetuity, such as a resource donated for a cancer wing must always be used for that cancer wing.

Nonprofit corporations do not have owners. Instead they are run by a board of directors. The appointment or election of these directors is specified in the documents upon which the organization is created.

Governmental Entities

In addition to nonprofit private corporations, some healthcare facilities are chartered by local, state, or federal governmental agencies. The Veterans Administration administers the largest organization of governmental healthcare facilities. This text will be focused on accounting rules for private and public entities. If you work for a governmental entity, you will find most of the accounting rules are the same. As with nonprofits, the key difference is the management of the equity portion of the business. The governmental entity owns the medical facility and will absorb any profits or losses.

Accounting rules are similar to those for private and public companies, but there are different technical rules for assets, liabilities, and equity that will not be covered in this text. These are highly technical accounting provisions related to assumptions and principals unique to governmental accounting rules.

1.2 Limited Liability Company (LLC)

Some states allow medical groups to be organized as **limited liability companies**, a company structure that provides liability protection similar to that of a corporation. The amount of liability protection does vary by state, as do the structures allowed. The designation falls between a corporation and a partnership or sole proprietorship. Most states do give the same liability protections as a corporation. The key advantage is that the legal and accounting requirements are not as expensive as those for corporations. The decision to set up as an LLC rather than a corporation should be made after consultation with an accountant and an attorney familiar with the laws in the owner's state.

The equity portion of the business can be more flexible with an LLC because the ownership can be proportioned by percentage rather than by shares, if the owners prefer that arrangement. Both partnerships and sole proprietorships can organize as an LLC. Accounting practices will depend upon whether the LLC is a partnership or a sole proprietorship.

1.3 The Partnership

A partnership is another form of business organization that brings together multiple parties. The specific definition of a partnership is an association of two or more persons to carry on a business for profit as co-owners. However, in some ways, this also seems to describe a corporation. What is it that uniquely pertains to a partnership and sets it apart from a corporation?

For starters, a partnership is not a separate legal entity. It is an association of persons. Partnerships are formed quite easily, without the necessity of any specific legal action. Indeed, by default, the mere joining together of persons for a profit-oriented business purpose is a partnership, unless some alternative action is undertaken to set up a corporation (or other entity type, such as a joint-venture agreement). Since partners can be held responsible for the actions of other partners, it is rare to see this form of ownership in the healthcare field today.

Unlike a corporation, a partnership has a **limited life**. In other words, the partnership passes with the death of a partner, and the partnership is legally dissolved. A new one may be immediately formed; written agreements usually make provisions for the **dissolution** and reformation upon the death of a partner. At other times, where a deceased partner was crucial to business operations, the dissolution may also trigger a cessation of business operations and formal **liquidation** of the entity. Clearly, this complicating feature is yet another limitation on the desirability of doing business as a partnership, especially in the healthcare industry.

1.4 The Sole Proprietorship

In simple terms, you can think of a sole proprietorship as a one-person partnership. It is not a partnership, but the legal and technical requirements operate in much the same way. No specific legal action is necessary to start the business, although there are a number of good practices. For instance, if an individual began doing business under an assumed name such as Jan's Assisted Living, she would likely want to file an assumed-named certificate, register an appropriate Internet site, notify licensing and tax agencies, and so forth. However, she does not need specific authorization to create an entity. Indeed, she is the entity. When doing business under an assumed name, procurement of the assumed-name certification is a very good business practice. This provides protection against other persons "copying" your business identity and is often required to conduct banking and other similar transactions. In many states, obtaining an assumed-name certificate is easily done through a county clerk's office, takes only a few minutes, and requires paying a small fee.

Sole proprietors are obviously responsible for their own debts. If the business fails, the business owner cannot just apologize and tell creditors the business no longer exists. Governance issues are nonexistent, for perhaps rather obvious reasons. There are no partners or shareholders; thus, sole proprietors answer only to themselves. Many sole proprietors in the healthcare profession organize as LLCs, if allowed in their state, to gain limited liability protection.

Table 1.1 highlights the key features of various forms of business organization. The features and observations are broad generalizations but provide a frame of reference to consider when selecting an entity structure.

Table 1.1: Features of various business organizations

	Sole Proprietorship	Partnership	LLC	Corporation	Nonprofit Corporation
Ease of formation	Yes	Yes	No	No	No
Multiple owners	No	Yes	Yes	Yes	Board of directors, no owners
Transferability	Not easily done	Not easily done	Not easily done	Easily done	Not applicable
Double taxation	No	No	No	Yes	No
Liability protection	No	No	Yes	Yes	Yes
Separate tax return	No	Yes	Yes, if partnership	Yes	Yes
Operating agility	High	Medium	Medium	Low	Low
Perpetual life	No	No	No	Yes	Yes
Degree of regulation	Low	Medium	Medium	High	High

As a manager or supervisor in a healthcare organization, it will be important to understand the types of organizational structures you may encounter. Since you will not likely be responsible for dividing equity or filing taxes, we will not discuss those topics in this text. Instead we focus on the accounting skills you need to manage in the healthcare field. In the next chapter, we begin by looking at the basics of accounting and its language.

Key Terms

dissolution The breakup of a partnership.

generally accepted accounting principles (GAAP) Rules accountants follow when preparing financial statements.

initial public offering (IPO) A privately held company's offering of the first sales of its stock to the public.

limited liability A principle of corporations stating that stockholders can only lose the amount of their investment to creditors.

limited liability companies A company structure that provides liability protection similar to that of a corporation.

limited life The nature of partnership in that partnership passes with the death of a partner.

liquidation The formal termination of an entity.

perpetual existence A characteristic of a corporation, meaning that it will continue to exist and operate until it is merged with another, it fails, or a corporate action is undertaken to liquidate the company.

Review Questions

The following questions relate to several issues raised in the chapter. Test your knowledge of these issues by selecting the best answer. (The odd-numbered answers appear in the answer appendix.)

1. Which is not a type of corporate entity?
   a. governmental
   b. nonprofit
   c. for-profit
   d. partnership
2. Why do many health organizations choose the corporate structure?
   a. limited liability
   b. ease of transferring ownership
   c. earn more money
   d. both a and b
3. Partnerships can be risky in the healthcare environment because
   a. partners must take responsibility for the actions of their partners.
   b. there are no limits to the liability they take in opening the business.
   c. the partnership must be dissolved if a partner dies.
   d. all of the above
4. Which type of organization divides equity by percentage of ownership?
   a. corporation
   b. partnership
   c. sole proprietorship
   d. none

5. Which type of organization divides equity by shares held?
   a. corporation
   b. partnership
   c. sole proprietorship
   d. none
6. What is a corporation? Discuss the advantages of the corporate form of organization.
7. Briefly explain the disadvantages of the corporate form of organization.
8. What is a partnership? Discuss why partnerships can be risky in medical organizations and how to reduce the risk.
9. How does the accounting differ for nonprofit organizations?