Understanding Your Key Financial Statements

These reports provide valuable practice information.

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Two of your practice's most important financial documents are the Profit and Loss Statement and the Balance Sheet. Many medical practice owners aren't clear on the difference between the two and how to strategically use each document to gain insight into their practice. All business owners, including physicians, should look at and digest the information on these documents at least quarterly, if not monthly.

The Balance Sheet Versus Profit and Loss Statement

A balance sheet is a statement that shows your practice's assets, liabilities, and equity at a specific date. Therefore, this document can help identify the practice's financial condition on any given date.

A significant difference between a balance sheet and a profit and loss statement is that the balance sheet is a statement. In contrast, the profit and loss statement is an account since it highlights the practice's revenue and expenses for a particular period. Additionally, the balance sheet highlights the practice's financial stability and liquidity, while the profit and loss statement focuses more on financial performance and profitability.

How They Are Used

Investors frequently use a balance sheet to evaluate a practice's financial stability and ability to pay its debt promptly. The investors will look at the practice's current assets, such as cash and inventory, and compare them to their current liabilities, such as accounts payable and loans.

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On the other hand, a profit and loss statement is used to evaluate the practice's ability to generate revenue and profit. To assess its financial performance, investors will measure the practice's revenue growth, gross profit margins, operating expenses, and net income.

The Components of a Balance Sheet

A Balance Sheet gets its name because its components (assets, liabilities, and equity) always need to "balance". Essentially, the Accounting Equation is as follows:

Assets = Liabilities + Equity

Assets

The accounts on a balance sheet are frequently listed from top to bottom in the order of how easily they can be converted into cash (known as liquidity). They are divided into current assets, which can be converted to cash in one year or less, and non-current or long-term assets, which take longer than a year to convert.

Current assets include:

- Cash and cash equivalents, which are the most liquid.
- Accounts receivables
- Inventory, such as DME and supplies
- Prepaid expenses, such as insurance, advertising, or rent already paid for.

Long-term assets include:

- Long-term investments that cannot be liquidated in the next year.

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• Fixed assets such as equipment and buildings.

Liabilities

A liability is any money a practice owes to suppliers, rent, utilities, and salaries. Current liabilities are due within one year, while long-term liabilities are due at any point after one year.

Current liabilities include:

• Accounts payable, often the most common current liability. Accounts payable are debt obligations on invoices often due within 30 days of receipt.

• Current portion of long-term debt due within the next 12 months. For example, if your practice has ten years left on a loan, one year is a current liability, and nine years is a long-term liability.

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• Interest payable.
• Wages payable.

Long-term liabilities include:

• Long-term debt

• Pension fund liability, which refers to the money your practice is required to pay into its employees' retirement accounts

• Deferred tax liability, referring to taxes due that will not be paid for another year.

Shareholder Equity

Shareholder equity is the money belonging to the owners of the practice. It is equivalent to the practice's total assets minus its liabilities or the debt it owes.

The Components of the Profit and Loss Statement

For a practice administrator, the profit and loss statement is the most critical document to decompose and analyze monthly, quarterly, and annually. Year over year, variance in revenue, expenses, and profits should be monitored.

The profit and loss statement also provides insight into the practice's "break-even point". Expenses itemized on the profit and loss statement are either fixed (unrelated to patient volume) or variable (directly related to patient volume). Totaling the variable expenses and dividing those by patient volume for the period (derived from the practice's management software) provides you with your Variable Cost Per Patient. Any encounter should have gross payments more than your variable cost per patient to contribute to a profit margin. Naturally, there will be exceptions, and this break-even point should only be evaluated at a high level. Consistent reimbursement below the variable cost per patient for any CPT code should be questioned. Isolated situations are expected, and perhaps no actions are required if other CPT code reimbursements from that same payer make up for the lower ones. But if a payer has reimbursements below the variable cost per patient for many CPT codes, a deselection of that payer might be necessary.

How About EBITDA?

EBITDA is an acronym—Earnings Before Interest, Taxes, Depreciation, and Amortization. Most valuation methods use EBITDA as the basis of determining value, in addition to considering the value of the hard assets. The depreciation, interest, taxes, and amortization expenses are removed or "adjusted out" from the Profit and Loss Statement. Therefore, the practice's bottom line is increased and referred to as EBITDA. Depreciation and amortization are removed since they are non-cash expenses.

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They merely represent tax deductions based upon a prior purchase of an asset, such as equipment. Interest is removed because the buyer normally does not assume any seller debt. Suppose the owner's salary is listed as either too high or too low on the Profit and Loss Statement? In that case, the owner's salary is replaced with a reasonable salary, and the EBITDA will be adjusted up or down by the difference. Income taxes are removed because the value of privately owned businesses is determined on a pre-tax basis.

Managing your practice and its growth is difficult if you ignore your financial position. Income statements and balance sheets are essential for entrepreneurs to track their revenue, expenses, and cash flow. You don't need to be a chief financial officer to produce these documents. Plenty of good accounting software is on the market, and either you or your accountant can generate these reports on a recurring basis. **PM**

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