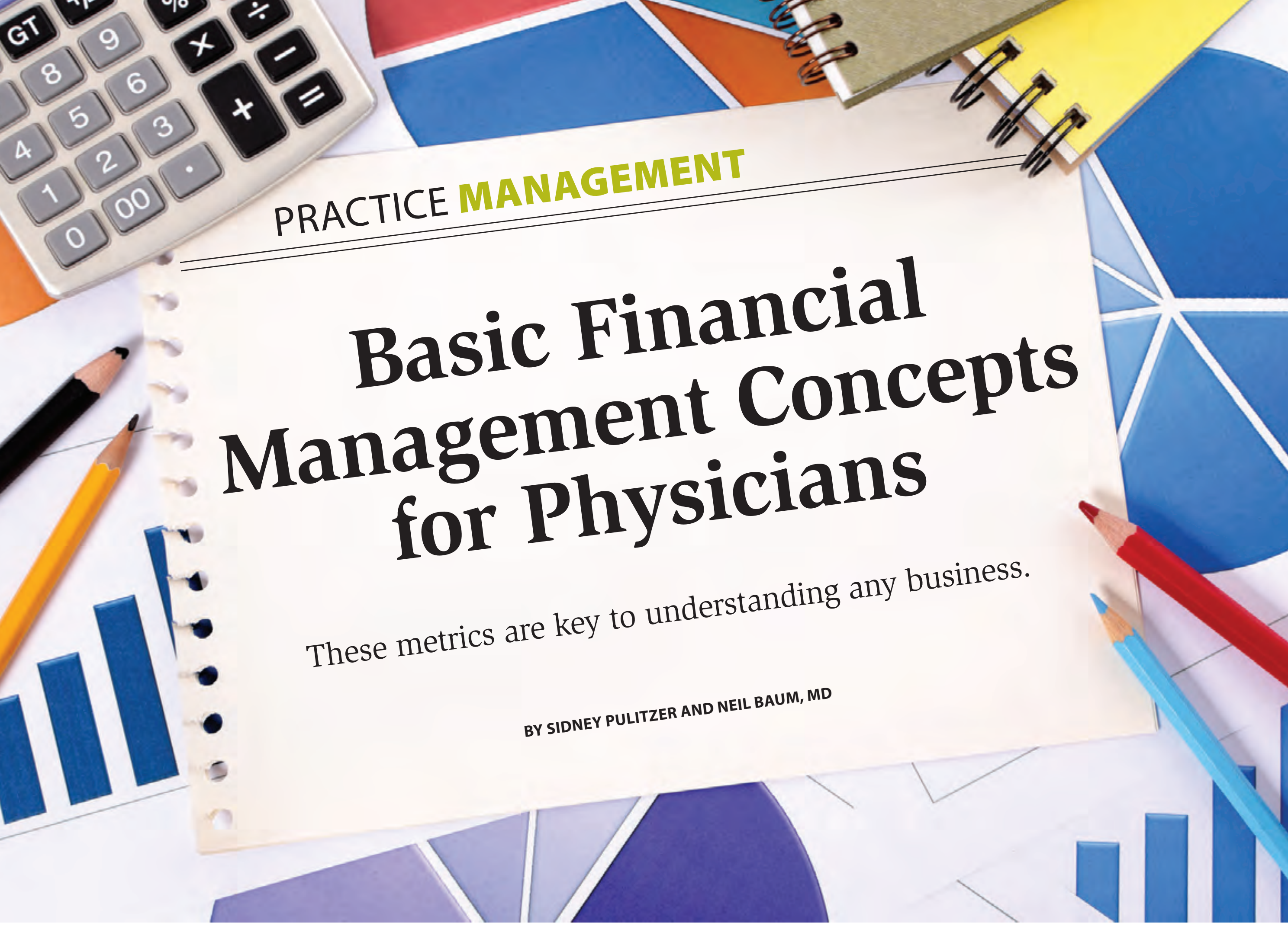

Basic Financial Management Concepts for Physicians

These metrics are key to understanding any business.

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The Hippocratic Oath that all doctors recite upon graduation from medical school promises that the physician's primary concern is to provide the best care for the patient. Unfortunately, doctors have a reputation for being poor businesspersons. This idea is based on the observation that doctors provide care to patients regardless of their ability to pay and put the patient's interest above other conflicting interests. Obtaining payment for our services is secondary.

Many people, including doctors, view financial accounting as a mysterious mathematical formula beyond their understanding. It is quite the opposite. Financial accounting requires only addition and subtraction. The concept of "bookkeeping" was invented by British sailors 300 years ago. Their livelihoods depended on knowing what goods and products were on their ships to make each voyage profitable. These sailors would have been unlikely candidates for a medical degree, so doctors should never be intimidated by financial accounting.

Many people, including doctors, view financial accounting as a mysterious mathematical formula beyond their understanding.

Until recently, the business management of a medical practice was not included as part of medical education or residency. Most medical schools still do not provide a course in financial accounting. Consequently, many doctors enter their medical practice financially naive or not making financial management a priority.

This article explains basic accounting with easy-to-understand commonsense logic. These basic accounting principles can be used to manage your practice and to make sound investment decisions. Our purpose is not to make you an accountant (just as a CPR course will not make you a cardiologist). These concepts provide you the confidence to look at a financial statement and determine whether the practice can pay its bills and is profitable.

The Financial Statement

Understanding the basic concepts of accounting allows you to manage your income and expenses over the years to accumulate sufficient wealth to retire comfortably. Earnings are needed to pay off your mortgage and debts

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and to accumulate money to invest in income-producing ventures so that you retire with reliable and predictable income. We suggest you remember that a medical career, like all professional careers, ends in retirement.

Think of the financial statement as a monetary physical exam of the practice. These documents show whether your business can pay its bills, whether it is earning a profit, how it looks to creditors, and what is the year-over-year trend. The financial statement communicates key ratios on solvency, debt, and the direction of your practice. The financial statement demonstrates the accumulation of profit, which increases the net worth of the practice, and also helps find weaknesses that need correction.

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Auditor's Letter

All medical offices need a qualified accounting staff. Ideally, your accounting staff has experience in managing medical practices. Auditors are highly qualified accountants who also have been licensed by their state to legally certify that a business's financial statement accurately reflects the actual financial condition of the practice. The auditor is required by law to perform tests to find errors and omissions and protect you from fraud. The auditor certifies that all accounting procedures are correct and that transactions are maintained daily. This ensures that your accounting department is functioning properly and should give you peace of mind that you are fully and accurately informed. The auditor oversees the preparation of your monthly, quarterly, and annual financial statements and tax returns. Finally, the auditor's letter gives banks and creditors confidence in your statement should you wish to borrow money.

The Books

The description "books" refers to two kinds of documents that are required to record all financial activities and then prepare the financial statement. They are the ledger and the T-accounts.

The Ledger

The ledger is a diary or journal recording all the business transactions occurring daily. Every entry re-

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quires at least one debit and one credit to describe each business transaction with the names of people and the amount of money involved. The total of debits and credits must be equal to avoid errors.

T-Accounts

An account is opened for every patient, vendor, insurance company, and other contact that a practice interacts with. Each account records all transactions in which it was involved, with debits and credits. Accounts fall into five categories: assets; liabilities; owner's equity; revenue; and expenses. These books record the practice's activity

The balance sheet is constructed from the totals in three kinds of accounts: assets; liabilities; and net worth.

and are kept secure and confidential. Keeping the ledger and accounts is not the doctor's job; it is the responsibility of the accounting staff. The doctor needs the auditor to tell them if they are doing their job.

The Balance Sheet

The balance sheet is constructed from the totals in three kinds of accounts: assets; liabilities; and net worth. It takes place in an instant of time and is always as of a specific date. It is like taking a financial snapshot of the practice. Your staff, accountants, and the auditor will "close the books" at a convenient time. The practice continues as usual, but new entries are not made until after the books are counted, totaled, tested for accuracy, and closed.

After that, accurate balance sheet and profit and loss (P&L) statements can be created.

The balance sheet has two columns listing the total value of all assets and total liabilities. The totals of the two columns must be the same: assets equal liabilities. The left column lists all assets, which include anything of value the practice owns, such as cash, accounts receivable (what patients or businesses owe the practice), inventory, and equipment. The right column totals all the liabilities or what the practice owes to others. Liabilities include bills owed to others and debts such as bank loans. It also includes net worth, also referred to as the "book" value of the practice.

Net worth is calculated by subtracting liabilities from the practice's total assets. The liabilities consist of what the practice owes to others. Net worth has two parts: the initial capital invested in starting the practice plus any accumulated profits or losses, referred to as surplus or deficit. The net worth, or book value, of a business does not necessarily match the market value. The market value is what a buyer is willing to pay.

Closing the books corrects all errors, because ac-

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counting uses the double entry system, which is self-correcting. There are two kinds of accounting systems: single-entry and double-entry. Your bank account is a single-entry system. You add all deposits and deduct all checks paid, leaving a running total that is supposed to match the money in the bank. What happens if you make an error and don't know about it? When you get your monthly bank statement, you "reconcile" the bank's total to your total and correct any mistakes. You need the bank's statement to do this.

This is where the double-entry system of bookkeeping is better. All transactions require two entries in the ledger, a debit and a credit. When the books are closed, the total of the debits and credits must balance and be the same. If they are not the same, any errors must be found and corrected. This is not the doctors' job—the accountants do the entries and balancing. Doctors need to focus on the reports provided by accountants. That's where the important operating results of the business can be found. Figure 1 depicts a typical medical balance sheet.

FIGURE 1

The Happy Day Medical LLC Balance Sheet
May 26, 2022

	2021	2022
ASSETS		
Cash and investments	$47,646.57	$56,421.10
Patient accounts receivable, net allowance	$156,879.54	$169,141.21
Supplies and inventory	$38,154.49	$31,024.77
TOTAL CURRENT ASSETS	**$242,680.60**	**$256,587.08**
Property, equipment net depreciation	$47,448.62	$54,279.36
Total assets	**$290,129.22**	**$310,866.44**
LIABILITIES AND EQUITY		
Accounts payable	$41,755.99	$42,876.23
Accrued salaries and expenses	$12,423.57	$13,248.66
Due to third-party payers	$16,756.81	$17,856.49
Total current liabilities	**$70,936.37**	**$73,981.38**
Long-term bank loan	$88,422.68	$38,467.21
Pension liabilities	$11,124.00	$5,500.00
TOTAL LIABILITIES	**$170,483.05**	**$117,948.59**
EQUITY		
Members	$25,000.00	$25,000.00
Surplus	$23,709.80	$93,936.47
TOTAL ASSETS	**$290,129.22**	**$310,866.44**

Figure 1: A typical medical practice balance sheet.

FIGURE 2

The Current Ratio and the Debt Ratio

	2021	2022
CURRENT RATIO		
Current assets	$242,680.60	$256,587.08
Current liabilities	$70,936.37	$73,981.38
Current ratio	**3.42/1**	**3.47/1**
DEBT RATIO		
Total equity	$48,709.80	$118,936.47
Debts	$88,422.68	$38,467.21
Debt ratio	**181.53%**	**32.34%**

Figure 2: The current ratio and the debt ratio.

Time and Liquidity

The balance sheet shows whether a practice can pay its bills. It separates assets and liabilities by the time frame of one year describing them as current assets and fixed assets. It is all about the solvency of the business—the critically important ability to pay all bills on time and maintain good credit. Current assets are assets that include cash and other assets that are likely to become cash (i.e., liquid) within one year and thus can be used to pay bills. These include cash, accounts receivable (i.e., money owed to the practice by patients, medical insurance companies, or the government), supplies, and inventory.

Fixed assets are equipment, computers, and furniture, which are not fungible and are difficult to convert into cash to pay bills. The same time frame of one year distinguishes current liabilities and fixed liabilities. Obligations that must be paid within one year are current liabilities. An example is accounts payable (i.e., bills owed to others). Fixed liabilities due for payment beyond one year also are called long-term liabilities. An example is a mortgage loan payable over many years.

The Current Ratio

The current ratio compares current assets to current liabilities to determine whether a business has

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the cash to pay its bills. The ratio is determined by dividing the current assets (cash or near-cash assets) by the current liabilities (what is owed for immediate payment). The widely accepted current ratio is to have $2 in current assets for every $1 in current liabilities, or a 2-to-1 ratio. For example, a practice with $20,000 in cash and other liquid assets and with $10,000 owed can easily pay all bills. Every medical practice monitors the receipt of money owed and follows up to collect payments from all accounts receivable so that its current ratio is at least 2-to-1 or better. It also may mean that control of spending must be managed. Look at the balance sheet in Figure 1 and compare the total current assets to current liabilities. See what kinds of assets and liabilities fit into each total.

Fixed expenses are those that occur even if no patients are seen and often are referred to as overhead.

The Debt Ratio

Debt is borrowed money that requires interest and principal payments to be made in regular monthly or quarterly intervals. Accounts payable should not be confused with debt. Accounts payable are business obligations the practice owes for purchases or services. The debt ratio is calculated by totaling all debts, regardless of date of maturity, be they current or long-term (e.g., due next year), and dividing that by total net worth. That is the percentage by which the net worth of the practice is currently obligated to creditors.

The scale of debt ratio risk should be monitored and kept under control:

- 0 to 28%: very low risk;
- 28% to 50%: moderate risk;
- 50% to 100%: dangerous; and
- Over 100%: danger of bankruptcy.

Figure 2 shows current ratios and debt ratios over two years. This medical practice has excellent current and debt ratios. Notice that the debt ratio has improved from 2021 to 2022.

The Profit and Loss Statement

The P&L statement totals all revenues and subtracts all expenses; what is left is a profit or loss. The P&L statement covers a time frame such as a month, a quarter, or a year. Over this period of time, a practice receives revenues and pays expenses. At the end of the period, if revenues are greater than expenses, a profit has been earned. Hooray! But if the expenses are greater than revenues, the business has suffered a loss and usually has less

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cash available. A profit is not easy to earn—it requires smart hard work. The Wharton School of Business defines profit as "the earned reward for efficiently supplying a social good."

Understanding Expenses

There are two important kinds of expenses: fixed and variable. Fixed expenses are those that occur even if no patients are seen and often are referred to as overhead. Examples include rent, utilities, insurance, and administrative costs. Fixed expenses even happen on weekends and holidays and even when you are not providing care for patients. Variable expenses occur only when patients are charged a fee for your services. Some examples of variable costs include staff salaries (excluding the physician salary), supplies, marketing expenses, printing, and postage.

The difference between the money received for your services, minus the cost to provide the service, is a contribution to covering the fixed costs. Suppose a doctor sees a patient and charges $100.00 for the service. The patient is also given a test and charged $50.00, for a total of $150.00 for the visit. The only variable cost is $15 for the supplies for the test. In this instance, the remaining $135.00 is the contribution to cover fixed costs. If a practice is to make money, the total of the contributions, called gross margin, must cover all fixed costs; the excess is the profit. Your accountant can help calculate the prices of charges needed so that the fixed costs are covered, leaving a fair and reasonable profit. Figure 3 shows a sample P&L statement.

FIGURE 3

The Family Medical LLC Profit and Loss Statement

May 1, 2022

	%	2021	2022
Revenue		**$965,733.21**	**$1,017,644.86**
Staff Expenses			
Employees	20.0%	$193,146.64	$205,528.97
Partners	30.0%	$295,719.96	$308,293.46
Payroll taxes	4.0%	$39,429.33	$41,105.79
Employee benefits	10.0%	$98,573.32	$102,764.49
Subtotal	**64.0%**	**$630,869.25**	**$657,692.71**
Clinical Expenses			
Medical	10.0%	$98,573.32	$102,764.49
Lab fees	5.0%	$49,286.66	$51,382.24
Subtotal	**15.0%**	**$147,859.98**	**$154,146.73**
Facility Expenses			
Rent	5.0%	$49,286.66	$51,382.24
Repairs and maintenance	0.5%	$4,928.67	$5,138.22
Taxes	1.0%	$9,857.33	$10,276.45
Utilities	1.5%	$14,786.00	$15,414.67
Subtotal	**8.0%**	**$78,858.66**	**$82,211.59**
Administrative			
Advertising and marketing	1.0%	$9,857.33	$10,276.45
Insurance	1.0%	$9,857.33	$10,276.45
Office supplies/expenses	1.5%	$14,786.00	$15,414.67
Legal and accounting	1.0%	$9,857.33	$10,276.45
Telephone	0.5%	$4,928.67	$5,138.22
Taxes and licenses	0.5%	$4,928.67	$5,138.22
Subtotal	6.0%	$59,143.99	$61,658.69
TOTAL EXPENSES	**93.0%**	**$916,731.89**	**$955,709.72**
INCOME	**7.0%**	**$49,001.32**	**$61,935.14**

Figure 3: A sample profit and loss statement.

Conclusion

The financial statement is the scorecard of your medical practice. It reflects the combination of hard work and wise management of revenues and expenses to earn a profit and grow the net worth of the practice. It is the numerical reflection of both your medical and management capabilities.

Let's not forget that a medical practice is a business, and it is both ethical and moral that it should generate a profit. We hope that this article emphasizes the important documents of the financial statement, and the policies needed for a medical practice to be solvent, earn a profit, and accumulate wealth so that doctors can retire successfully. **PM**

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