



Most doctors have a limited understanding of how to interpret their financial statements, even though they're essential tools for all business owners, investors, and anyone else who is interested in understanding the financial health and success of their organizations. Three primary financial statements are the balance sheet, the profit & loss statement (also called the income statement), and the cash flow statement. Each offers unique insight into the finances of a company or a medical practice. This article will guide you through the purpose, structure, and interpretation of these three key financial statements.

There are different types of podiatric practices, ranging from solo with one owner to groups with multiple owners or associates who eventually might want to become owners. The solo and group models are typically private practices that may

be either partnerships or incorporated. With the advent of private equity buyers, there are now even larger, sometimes multi-state, group models and networks. Regardless of which model you are, it is important to un-

derstand how to read its financial statements. confidence in the profitability of the businesses, closely held businesses are "private" and are not as scrutinized and regulated.

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While the tax returns for partnerships and incorporated practices differ, both are considered *closely held* businesses, and this makes interpretation of their financial statements challenging. Unlike public companies or private equity-based podiatric networks, which typically have detailed and audited financial information that give investors and management

diatric practice may include such things as income or expenses that are unrelated to the operations of the business, owners who may be overpaid (or underpaid) relative to comparable positions in similar practices, family members who are on the payroll but not actually performing any substantive work, and other "blurring" of personal and business expenses that make it difficult to de-

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termine the actual profitability of the practice. Understanding the significant differences in the accounting of public companies and privately held businesses is important to avoiding misinterpretation of their financial reports.

The Balance Sheet

This provides a snapshot of a company's financial position at a specific point in time. It displays what the company owns (assets), what it owes (liabilities), and the owner's equity (the residual interest in assets after deducting liabilities). The balance sheet follows the basic accounting equation: $\text{Equity} = \text{Assets} - \text{Liabilities}$. Assets are resources owned by the practice such as cash, inventory, accounts receivable, property, and equipment. Liabilities are obligations or debts the practice owes to others such as loans, accounts payable, and

mortgages. Equity is the owner's or shareholders' claim after all liabilities have been settled, including retained earnings and capital contributions.

It is important to note that other than cash, the value of assets

for \$10,000 and seen it depreciate at \$2,000 per year over five years. The balance sheet will then list the value of that piece of equipment as zero, but it obviously still has some value if the practice is sold. Some practice

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on the balance sheet do not represent their actual value. Real estate value is listed at the original purchase price, not the appreciated (or depreciated) value. Equipment and other hard assets depreciate over time, and once equipment is fully depreciated, its value on the balance sheet going forward will be listed as "zero." For example, a physician may have purchased a piece of equipment

valuators assign an "in-place value" to certain equipment because it is part of a working system that helps produce revenue for the physician.

Analysis of the balance sheet gives the owner and stakeholders an assessment of the practice's liquidity (ability to meet short-term obligations), solvency (long-term financial stability), and capital structure.

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The Profit & Loss Statement (Income Statement)

The profit & loss statement, the P&L or income statement, shows the company's performance over a period of time (e.g., a quarter or a year). It details how much revenue the company generated, the expenses incurred, and the resulting profit or loss for that period. The main components are: (1) revenue or sales, which is the total income earned from selling goods or services, (2) cost of goods sold (COGS), which are the direct costs of medical supplies or supplies sold, (3) gross profit, which is revenue minus COGS, (4) operating expenses, which are the costs related to running the business, such as salaries, rent, utilities, and marketing, (5) operating profit, which is gross profit minus operating expenses, (6) other income and expenses, which are non-operating items such as interest income or gains or losses on sales of assets, and (7) net profit (net income), which is the practice's overall profit after all expenses have been deducted from the total revenue.

The profit and loss statement establishes how well the company is managing its revenues and expenses, regardless of whether it is profitable. Many physicians do not understand what profit actually is. Most practice owners believe that it is simply the amount remaining after paying all expenses, with that amount becoming their salary. In reality, this "salary" is not the same as profit. Rather, profit is the amount that remains after paying all expenses, including a physician's salary. When determining profit to value a practice, it is important to understand the definition of "normalized salary". This is the amount a buyer would need to pay a replacement doctor who could produce the same revenue as the current owner. When valuing a practice for sale or merger in which the physician had not been paid a specified salary, the valuator first determines this normalized salary and subtracts it from the amount remaining, after paying all expenses. What is left is the actual profit, which is then used to arrive at the practice's final valuation.

The Cash Flow Statement

The cash flow statement tracks the movement of cash in and out of the business over a specified period. It is divided into three main sections: (1) operating activities, which is cash generated or used in the core business operations (e.g., cash received from patients or third-party payers, or cash paid for supplies and employee salaries), (2) investing activities, which is cash used for or generated from investments in assets, such as purchasing equipment or selling investments, and (3) financing activities, which is

tion of the balance sheet as "retained earnings". The cash flow statement reconciles net income with actual cash generated from operating activities. It starts with the net income from the profit and loss statement, and non-cash expenses (e.g., depreciation) are added back onto the cash flow statement. Activities such as purchasing assets impact the balance sheet and the cash flow statement. Changes in assets and liabilities on the balance sheet are reflected in the cash flow statement. For example, a decrease in working capital from the

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cash flow related to borrowing, repaying debt, issuing shares, paying dividends, and budgeting.

While the profit and loss statement shows profitability, the cash flow statement reveals the practice's actual liquidity. This is the amount of cash that is available to fund operations, pay debts, or invest in growth. Staying "on top of" the cash flow statement helps medical practitioners ensure that they have enough cash on hand to meet day-to-day expenses, thus avoiding shortfalls. Regular review of the cash flow statement allows a physician or practice manager to spot trends such as delays in insurance payments or rising operational costs. This statement can also be used to assist in making strategic decisions such as hiring staff, expanding services, purchasing new equipment, or opening additional locations.

How These Financial Statements Work Together

Much like podiatrists take three, rather than one, x-ray views when diagnosing a foot problem, each financial statement offers its unique perspective and provides its own picture of a practice's financial health, and the three are interconnected. For example, the profit & loss statement's net income feeds into the equity sec-

tion of the balance sheet is adjusted to show true cash generated from operations. It is important to understand all three reports and their interconnections.

Analysis of these three financial statements creates a comprehensive view of a practice's financial health, performance, value, and potential risks. An understanding of all is essential for making informed business decisions. These statements can be utilized for supporting loan and credit applications and for strategic planning. Whether you are a practice owner, office manager, a doctor considering buying into or selling a practice, or a member of a large group network, a better understanding of these financial statements will help you assess your practice's financial performance, identify trends, and spot potential risks. Regular review and analysis of these statements are key to understanding your practice's financial health and achieving long-term financial success. **PM**



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