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## Getting Started In Private Practice – Financial Information To Review and See

Fully armed with clinical knowledge, it is now important to develop a basic financial understanding on the "business" of medicine generally and your specialty specifically. You need this skill when you are interviewing and comparing different practices you are considering joining.

The practices you are considering most likely all performed well economically, as evidenced by their desire to expand and hire you. But, how does this practice compare to its peers? Why does it differ? How will those differences change or affect its long-term performance? What information would you look at to know? Would that information, if provided, tell you anything?

### EVALUATING AN EXISTING MEDICAL PRACTICE

Once you have an offer to join a practice, it is appropriate to ask basic questions about the Practice's financial position – assuming this information has not already been shared. Recognize that as an employee (or potential-employee) of the practice, before you are invited into ownership, some financial information may not be available to you. In fact, some financial information may be deemed by the Practice to be a highly confidential "trade secret." On the other hand, if your offer contains co-ownership terms, you should be entitled to know what to expect when you become a co-owner.

So, what information should you request now? Most certainly, you should have basic financial information, such as generally what the current practices earn (on average), so you can see your future. You should know generally how they divide their income (equally, by productivity, or a hybrid of equal/productivity), so you have some idea of what you might earn as a partner. You should also know how you will get busy (on your own, by referral from partners, etc.), how busy you will likely be, and the plan to help you attract that work.

Beyond talking generalities, cases and expectations, many fellows believe they should see "Financial Statements" or "Balance Sheets." However, requesting such items without understanding what they are, or what information you would learn from them is about as useful as showing your patient her x-ray and leaving the room. In both cases, you and your patient may still be left wondering what the information means and if you weren't better off with the interpretation.

### BASICS OF MEDICAL PRACTICE ACCOUNTING

**1. Methods of Accounting.** There are two basic methods of accounting for the income and expenses of a practice: cash and accrual. *Cash accounting* recognizes revenue when it is received and expenses when they are paid. *Accrual accounting* recognizes revenue when the services are rendered and expenses when they are incurred. (Prepaid expenses are considered assets and accrued expenses are therefore considered liabilities.)

Generally the cash method of accounting is preferable in medical practices for two reasons: (i) cash actually collected (as opposed to "charged") and expenses when actually paid are "provable" realities - they are also indicative of the way most physicians "think" (right or wrong); (ii) the variety of income adjustments (Medicare write-offs, insurance adjustments, etc.) is, at a minimum, subjective and therefore subject to continual re-evaluation; (iii) you pay less taxes generally, as you do not recognize your uncollected accounts receivable as income until they are collected. On the other hand, the accrual method of accounting more accurately portrays the Practice financial picture.

Since most medical practices are cash basis taxpayers, they maintain their accounting this way. Knowing how the Practice reports its income and expenses is a critical place to start, so that your comparison is consistent from one practice to another.

Remember that on all accrual basis, accounts receivable, although not collected, may be shown as anticipated income, whereas the cash method shows actual collections only as a result, on an accrual basis, the income (and expenses) will appear higher than it stated on a cash basis.

**2. Financial Statements.** A Financial statement, also referred to as a "P & L" Statement (for Profit and Loss) is simply a presentation, in varying formats, summarizing the categories of inflows (income) and outflows (expenses). Statements should be on a "cash basis," and most likely are, but you will know by whether or not accounts receivables or other "accrued" items are included.

There are a number of reasons to look at the Financial Statements. One is to see and to compare the actual income and expenses of the practice. You can then use this information to see both how the practice compares to its peer groups *and* to itself over time. More important than the actual "numbers" are the comparisons. One such "comparison" is the overall "profitability" of the Practice - the ratio between physician compensation and retained profit to gross income. For example, is its gross income increasing or decreasing? How much does it increase when new physicians are added? How "profitable" is the practice? Recognizing that there is no "right" answer for practices, and depending on the mix of provider subspecialties and ancillary services available, practices can generate anywhere between \$0.25 and \$0.60 per \$1.00 to their owner physicians. However, there also tend to be enormous regional fluctuations in these ranges as well.

Here is a sample Income Statement for a practice of four physicians.

**XYZ PRACTICE, P.C.\*  
INCOME STATEMENT  
FOR THE YEAR ENDED DECEMBER 31, 2006**

	4 Doctors	% of Income
Professional Charges	\$10,000,000	
Professional Receipts	\$3,880,000	
Other Income	\$ 79,500	
 TOTAL Income	 \$3,959,500	
 Automobiles	 (\$ 22,300)	 0.6%
Billing service	(\$ 62,000)	1.6%
Business insurance	(\$ 10,800)	0.3%
Dues, subscriptions	(\$ 14,000)	0.4%
Equipment	(\$162,500)	4.1%
Interest	(\$ 79,000)	2.0%
Lab fees	(\$ 49,900)	1.3%
Malpractice	(\$ 62,000)	1.6%
Miscellaneous	(\$ 48,000)	1.2%
Professional fees	(\$ 45,400)	1.1%
Professional promotion	(\$ 6,000)	0.2%
Staff Benefits	(\$ 87,400)	2.2%
Staff Pension/Profit Sharing	(\$ 84,600)	2.1%
Staff Salaries	(\$684,000)	17.2%
Medical Supplies	(\$191,600)	4.8%
Office Expense	(\$ 57,500)	1.5%
Taxes	(\$110,000)	2.8%
Telephones	(\$ 33,000)	0.8%
Utilities & rent	(\$141,500)	3.6%
 TOTAL EXPENSES	 (\$1,951,500)	 45.4%
 GROSS PROFITS	 \$2,008,000	 54.6%
 Doctor Benefits	 (176,000)	
 NET PROFIT	 \$1,832,000	
Per Doctor	\$458,000	
# months receivables out	1.7	

The focus here should be on the comparison of numbers from one practice to another and for the same practice over time. Ideally, you will see the current and prior years' statements. (Note that you should break down the statement to a "per doctor" basis to facilitate this comparison.) For example, issues raised from the Financial Statement consist of the following:

- Is the Gross Income decreasing, the same, or increasing over time and why?
- How does the Gross Income (all professional income) compare to that of other similarly situated practices?
- If you can tell, how much revenue is derived from professional services? From ancillary services? Where is the growth in the business? Is it geographic?
- How does the Net Income (physician compensation and benefits) compare over time? To its peer groups?
- In the areas of variance (personnel, etc.) why is this Practice so different? (Does it employ more people, or employ the same number but pay them more?)

**3. The Balance Sheet.** A balance sheet is a snapshot of the practice assets, liabilities and equity, usually at its fiscal year-end, showing the "value" of the practice. On a balance sheet, practice assets must always equal liabilities plus (investor/owner) equity. Stated differently:

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

If you are offered a co-ownership position, you will likely be asked to pay a proportionate share of the equity, as well as to assume your proportionate share of the debt. Thus, the balance sheet is a helpful starting point. The balance sheet, as the "snapshot" of the practice's assets and liabilities, would usually be presented as follows:

### XYZ PRACTICE, P.C. BALANCE SHEET

DECEMBER 31, 2006

<b>Assets</b>		<b>Liabilities and Equity:</b>	
<b>Current Assets</b>		<b>Current Liabilities</b>	\$320,000
Cash	\$100,000	Accounts Payable	\$150,000
Deposits	\$ 5,000	Accrued Expenses	\$ 50,000
Furniture    Fixtures	\$1,300,000	Notes Payable	\$120,000
and Equipment			
Medical equipment	\$1,450,000	<b>Long term debt</b>	\$1,050,000
Office equipment	\$150,000		
Less: Accum Deprec	(\$300,000)	<b>Shareholders' Equity</b>	\$ 35,000
<b>Total Assets</b>	<b>\$1,405,000</b>	<b>Total Liabilities and Shareholders' Equity</b>	<b>\$1,405,000</b>

When considering the Balance Sheet, look at its overall structure. For non-hospital based practices, assets are usually very high.

- Has the Practice continued to replace assets, or are its asset values nearly offset by the depreciation on those same items?

- How much debt does the Practice carry? Is it more (or less) than its cash and assets?
- How leveraged is the Practice? How does it compare to its peers? Over time to itself?

Notice that the assets are typical here. The more technical (expensive) equipment the practice owns, the greater the asset values on the balance sheet. On the other hand, many practices use debt (loans or financing arrangements) to pay for that equipment -- particularly highly technical or expensive items -- so there may be corresponding debt associated with the equipment. Note also that many practices lease highly technical equipment, and those leases may not even be shown on the balance sheets.

When looking at a "Balance Sheet," know that each word is a term of art. The use of the word *current* in assets and liabilities means that the item either converts to cash or is due within one (operating) year of the date on the statement. *Equity* includes capital stock, paid in capital (purchased equity) and retained earnings. Recall that Retained Earnings is part of (Shareholder) equity. Thus in a corporate setting, *Retained Earnings* is a fluctuating account that is part of the result of "Assets - Liabilities."

So, as a newly practicing physician, you look to the Financial Statements (Cash Basis) to see what you might earn. Similarly, you look to the Practice Balance Sheet to see what that co-ownership offer might cost you. What other reports or information might help you understand the Practice? Consider the following ratios:

Practice Overhead	=	$\frac{\text{Operational Expenses}}{\text{Gross Income}}$
Ideally	=	40% - 65%*
*Highly variable depending on the mix of (sub) specialists and technology		

Practice Payroll Percent =	$\frac{\text{Total Non-Physician Personnel Expense}}{\text{Gross Income}}$
	= 22% - 28%*
*Highly variable dependent on the specialty, the staff needed, the mix of (sub) specialists, ancillary services, and number of satellite offices.	

## NUTS AND BOLTS OF MANAGING YOUR PRACTICE FINANCES

### Measuring Profitability

It is a fallacy that if you make more money you are more profitable. Most practices do not spend enough time on "planning to profit." Thus, they tend to spend more when they make more.

Also, consider debt. If you take on more debt (borrow money), you incur debt financing (interest plus repayment), but this may give you more income, if you use the debt to purchase income-generating assets (such as equipment that helps generate technical fees). If you work harder, you generally make more money overall, but unless you work "smarter" too, you may not take home more income. What is important is how the numbers work together, not (necessarily) what they actually represent.

You should be looking at operational statistics and, although these vary enormously and are highly dependent on the Practice subspecialty, emphasis and personality, you should get a feel for how the practice compares in the following areas:

- Total New Patients / Year / Doctor
- Total Visits / Year / Doctor
- Total Procedures and Tests (Varying according to specialty)
- Total Diagnostics (Varying according to specialty)

Look not for "answers" but for trends in the same practice over time and between one practice and another.

Throughout this process of evaluation, also consider if the Practice has a Plan. Does the Practice really understand how and why it makes money? What is the Plan for physician compensation? Growth in equity?

Assuming the Practice has a plan (which it should) then explore the following:

### **The Practice Marketing and Business Plan.**

This is a three to five year projection for practice growth, and what actions the practice will take to achieve those objectives. For example, the Practice may plan to expand by adding associates. How will those associates make money? How many patients will they see? Where will those patients come from? What services will they offer? *What are the expectations for work effort?*

The projections will help you to take a more realistic look at the place of the Practice in the community. In addition, they tell you two things: (1) that there is a *Plan to succeed*; and (2) what the Plan is, *what it means to you, and now, most importantly, what is expected of you.*

### **The Practice Budget.**

This is the essence of sound financial planning, so all medical practices should have one in place to track financial progress. The budget can have a variety of uses:

- Monitor finances: a measuring stick of this year's status over last year's
- Set practice and individual goals; growth and success come from goals
- Make decisions promotional expenses, equipment purchases, borrowing needs, etc.
- Set physicians' draws and salaries
- Permit monthly retirement plan contributions, taking advantage of compounding of interest and maximum plan growth

The importance of a budget is to plan for the timing of revenue and expenses. It tells you how new technology will be paid for, where the money will come from, how it shall be returned, and why the investment is being made (presumably to earn more - but how much more, and when?)

## Financial Reports.

Once you are on your way to co-ownership there will be a number of additional reports that you should consider all of which will provide you with a measurement of the Practice over time.

Income Category	This Month	Last Year	Year-to-Date	Year-to-Date Last Year
By office				
By source				
By payor (HMO, BS, self-pay, etc.)				
<b>Overhead Expenses</b>				
Rents				
Office salaries				
Other categories				
<b>Doctor Expenses</b>				
Salaries				
Retirement contributions				

## Other Information and Ratios

$$\text{Collection Ratio} = \frac{\text{Gross Practice Receipts}}{\text{Practice Charges (Net of Disallowances)}}$$

An indication of effectiveness of your billing and collecting protocols

This ratio indicates the revenue that is collected from each dollar charged. From this ratio, you can estimate the amount of services that must be rendered (in charges) to provide a certain level of collections.

$$\text{Net Collection Ratio} = \frac{\text{Net Collections}}{\text{Net Charges - (Contractual Adjustments + Write-Offs)}}$$

This ratio indicates the revenue that is collected from each dollar of *net* charges. Net charges are gross charges less contractual adjustments and write-offs. A collection ratio of less than 100 percent would occur from bad debts and/or an increase in accounts receivable.

$$\text{Overhead Ratio} = \frac{\text{Operating Expenses}}{\text{Practice Receipts (Non-physician Expenses)}}$$

- If you use Physician Assistants, exclude their salaries from expenses

This ratio monitors your overall profitability from practice and shows the cost of supporting the professionals who generate the income of the practice.

$$\text{Accounts Receivable Ratio} = \frac{\text{Total Outstanding Accounts Receivable}}{\text{Total Practice Income (Receipts)}}$$

This ratio tells you how many months of income are tied up in outstanding debts to the practice.

$$\text{Average Collection Period} = \frac{\text{Accounts Receivable (Total, Collectible)}}{\text{Average Daily Billing}}$$

This ratio tells you how many days' receivables are out, and measures the overall effectiveness of your receivables systems.

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