Making Your Balance Sheet Work for You

Once you know how to read it, your balance sheet will tell you volumes about the financial health of your practice.

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Every physician practicing today should know how to read basic financial statements, starting with a balance sheet. Why? To begin with, it will equip you to sit down with your bookkeeper, accountant, administrator or chief financial officer and discuss finances in a way that demonstrates that you understand the bottom line. And, if you find yourself in negotiations, whether for a raise or the sale of your practice, a healthy understanding of the numbers will empower you. After all, banks use financial statements to decide whether to lend your practice money; hospitals review them to determine whether they want to purchase your practice and how much they're willing to pay for it; and your employer (if you're employed) uses them to calculate the organization's profitability and, in effect, to determine how much money is available for your raise. Why should you be the only one who doesn't know what is going on?

Every physician practicing today should know how to read basic financial statements.

What is a balance sheet?

A balance sheet shows what your practice owns (in accounting terms, your *assets*), what it owes (your *liabilities*) and what you have put in it based on your original costs (your *net equity,* or *fund balances* if your practice is a nonprofit organization). It also gives you an indication of your practice's ability to pay its bills (your *liquidity*) and its ability to weather an economic downturn or finance growth (your *solvency*). Key points to remember are these:

- A balance sheet balances. That is, the total of what a practice owns (its assets) equals the combined total of what it owes and what the owners have invested in it (liabilities plus equity).
- A balance sheet is a snapshot. It provides you with a picture of the financial health of your practice or organization on a certain date. By comparing snapshots, you can assess where you are in relation to where you want to be and take corrective action if necessary.

Basic concepts

The balance sheet on page 28 actually combines two financial snapshots of the Hometown Family Medical Group – one taken on Dec. 31, 1999, and one taken exactly a year later. Notice that the information is presented on a per-FTE (full-time equivalent) physician basis. This facilitates comparison

KEY POINTS

- A little knowledge of accounting will help you better understand the information your accountant, administrator or banker provides and will empower you to act on that information.
- A balance sheet is a financial snapshot. It summarizes the financial status of an organization at a given point in time.
- A balance sheet shows the assets of a practice and the extent to which those assets were financed with borrowed money and with the owners' money.

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Learning to read financial statements will give you a better understanding of what your accountant, administrator or chief financial officer is saying.

A balance sheet shows what a practice owns (its assets), what it owes (its liabilities) and what the owners have in it, based on original costs (its net equity).

It will also give you a good indication of your practice's ability to pay its bills, weather an economic downturn or finance growth.

A balance sheet always balances.

of practices of different sizes. Like most balance sheets, this one is organized according to generally accepted accounting principles (GAAP; the accounting profession's "rule book" for preparing financial statements). Assets (i.e., the group's resources) are listed at the top, with liabilities and equity below. Note that the "Total assets" line in each snapshot equals the "Total liabilities & equity" line. That's because of where assets come from: Assets financed with the group's own money are considered equity while assets financed using other means (e.g., bank loans) are called liabilities.

According to GAAP, assets are listed on a balance sheet in liquidation order, with the most liquid asset (cash) appearing first. Typical assets of a practice (in liquidation order) include:

Current assets. These are anything owned by the practice that could be sold or converted into cash within one year. This includes cash on hand and in bank accounts, accounts receivable (minus the accounts you're unlikely to collect) and prepaid expenses, such as insurance and inventory (e.g., office and medical supplies). Notice that inventory isn't listed on the sample balance sheet. In most cases, practices do not have enough tangible investment in inventory to merit its inclusion. An exception would be a practice that also runs its own pharmacy. In this case, inventory would include the cost of medication on hand to be sold.

Long-term assets. These are anything with a useful life that extends beyond one year, including property that the practice owns or leases (e.g., buildings, office furniture, computers and medical equipment) less accumulated depreciation (i.e., the cost of the item spread over the years of its estimated useful life). Net long-term assets are long-term assets minus accumulated depreciation.

Other assets. These include such things as investments and security deposits for rent.

Total assets. Current assets plus long-term assets equals total assets.

Like assets, liabilities are listed as *current* or *long term*:

Current liabilities. These are anything that must be paid within the next 12 months, including accounts payable, wages payable and payroll taxes payable.

Long-term debt. This is anything due over a period of many years (generally more than eight), including the mortgage on your building and loan payments.

The final major element of the balance sheet is equity. Generally, equity includes assets financed by a practice's owners or net profit that's retained in the business. In a nonprofit organization, equity is referred to as "fund balances."

The fundamental equation embodied by the balance sheet is this:

Assets = Liabilities + Equity

If that seems counterintuitive at first, think of it in a slightly different form: The

SAMPLE BALANCE SHEET

Hometown Family Medicine Group
Balance Sheet, Dec. 31, 1999, and Dec. 31, 2000
(per FTE physician)

	2000	1999
ASSETS		
Cash	$20,338	14,375
Accounts Receivable	60,869	82,381
Less allowance for doubtful accounts	(249)	(1,235)
Prepaid Expenses	6,823	6,284
Total Current Assets	87,356	101,805
Buildings, Furniture and Equipment	35,859	20,310
Less Accumulated Depreciation	(4,791)	(4,064)
Net Long-Term Assets	31,068	16,248
Other Assets		
TOTAL ASSETS	$118,424	118,053
LIABILITIES & EQUITY		
Retirement Plan Payable	$5,886	4,528
Payroll Taxes Payable	6,416	5,545
Notes Payable	560	3,943
Current Liabilities	12,862	14,061
Long-Term Debt	27,593	27,789
TOTAL LIABILITIES	40,455	41,850
EQUITY (Fund Balances)	77,969	76,203
TOTAL LIABILITIES & EQUITY	$118,424	118,053

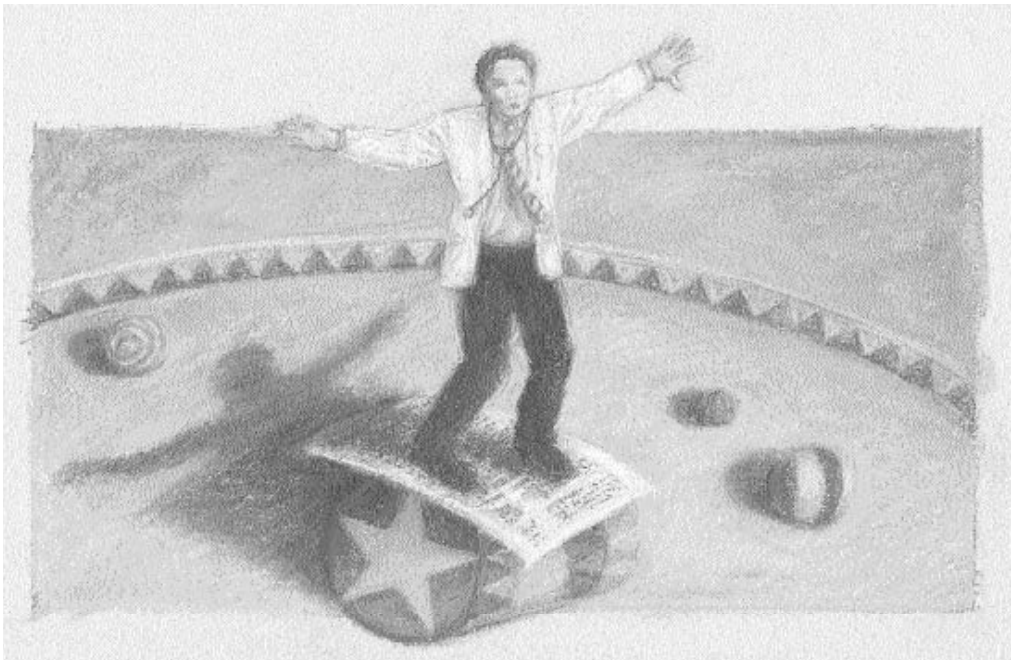

ILLUSTRATION BY TINA FONG

equity in a practice equals the assets of the practice minus what the practice owes.

The balance sheet for your practice may be more complex to look at than our example, but you'll see that it embodies the same principles – with one possible exception: If your balance sheet does not list accounts receivable as an asset, chances are that your practice uses what's called cash-based accounting. (See "Cash-based vs. accrual-based accounting" on page 30.)

Effects of common transactions

The next step to understanding a balance sheet is to look at the effect common transactions have on it. For example, assume that the sample balance sheet on page 28 is for your practice. Let's say that in 2000 you decided to invest $20,000 of your own money into the practice to buy new durable medical equipment. As you would expect, the $20,000 of equipment should be added to the "Building, furniture and equipment" line in the assets column on the balance sheet, bringing total assets for the current year to $138,424. But according to the basic equation above, either liabilities or equity has to increase by the same $20,000. Liabilities wouldn't be affected because you didn't borrow any money. They remain at $40,455. Since you put the money into the practice, your shareholder equity would increase by $20,000, bringing equity to $97,969 and the sum of liability and equity to $138,424.

Similarly, if you had borrowed from the bank to purchase a piece of durable medical equipment, you'd add the amount you borrowed to both your long-term debt and to your assets (i.e., the "Buildings, furniture and equipment" line).

If the practice had paid cash for the same piece of equipment, you'd deduct the purchase price from the "Cash" line and add it to the "Building, furniture and equipment" line. Your assets would be allocated differently, but your liabilities wouldn't be affected since money wasn't borrowed.

Perhaps your staff makes a concentrated effort and increases the collection rate for accounts receivable. Money on your balance sheet would move from "Accounts receivable" to "Cash." Total assets wouldn't change, but you'd have more cash on hand to invest in the practice, pay bills or take home as salary or bonuses. Notice how, as money moves around in all of these examples, the balance sheet remains balanced.

Interpreting balance sheets

Of the three key elements of financial success – liquidity, solvency and profitability – a balance sheet gives you the first two. (Profitability is the job of the income statement.) There's a hitch, though: If your practice uses cash-based accounting, you'll need to do a little additional math to produce an accrual-based version of the balance sheet. To start, add your accounts receivable to the current assets shown on your practice's balance

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Assets are listed on a balance sheet with the most liquid asset (cash) appearing first.

Liabilities are listed as current (i.e., anything that must be paid within the next year) and long-term (i.e., anything that is due over a period of years).

The fundamental equation embodied by a balance sheet is assets equals liabilities plus equity.

Or, looking at it another way, the equity in a practice equals the assets of the practice minus what the practice owes.

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In order to read a balance sheet correctly, you must determine whether it reflects a cash-based or accrual-based method of accounting.

Practices that use cash-based accounting do not list accounts receivable on their balance sheets.

With cash-based accounting, revenue is recorded and taxes are due only when accounts receivable are actually collected.

With accrual-based accounting, revenue is recorded when it's earned and expenses are recorded when they're incurred.

sheet. You'll also need to add this same amount to equity as "deferred income" (that's because your accounts receivable are part of what has been invested in your practice). Then add accounts payable and accrued retirement plan payable to the current liabilities and decrease equity by a corresponding amount. Typically, retirement plan contributions are not recorded on the books until the end of the year so if you're producing a balance sheet before the books are closed, you'll have to estimate based on previous years' results and your current performance. Finally, check to see if total liabilities include any loans from the practice's owners. Banks consider loans by owners to be equity, not liabilities. So if your balance sheet lists these loans under total liabilities, you'll have to move them into the equity column.

Liquidity is a measure of your ability to pay your bills. A balance sheet can tell you if you have enough cash and current assets (remember, those are assets that can be converted into cash fairly quickly) to pay your bills for the next year. Measuring liquidity requires calculating your practice's *current ratio* (see "Basic accounting equations," page 31). The current ratio equals current assets divided by current liabilities. Looking at the sample balance sheet, Hometown Family Medicine Group has current assets of $87,356 and current liabilities of $12,862 as of Dec. 31, 2000, so the current ratio is calculated as follows:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$87,356}{\$12,862} = \$6.79$$

There is $6.79 in current assets for every $1 in current liabilities, giving Hometown Family Medicine Group a current ratio of about 6.8 to 1. The practice is in excellent shape to pay its bills. Most nonmedical businesses have lower ratios, usually striving for a "gold standard" of about 2 to 1. Banks also consider this to be the gold standard for medical practices, even though practices tend to have higher ratios than other businesses because of the small amount of debt they usually carry.

CASH-BASED VS. ACCRUAL-BASED ACCOUNTING

All financial statements are either cash based or accrual based. With cash-based accounting, a transaction is not recorded on the books until payment for that transaction has been received or paid out. With accrual-based accounting, on the other hand, revenue is recorded when it is earned and expenses are recorded when they're incurred, no matter when the money changes hands.

Most physician practices are set up as "personal service corporations," giving them the option of using cash-based accounting. This means that revenue is recorded and taxes are due when accounts receivable are actually collected. One benefit of this arrangement is that the practice pays taxes only on money already in the practice. On the other hand, professional service corporations are also taxed at a higher rate: 35 percent of the first $50,000 of income compared with 15 percent for other types of corporations. This influences the financial objectives of the practice. Instead of accumulating income as reserves, practices operating as personal service corporations want to pay out as much as possible in salaries and bonuses. Why? Because the less income left on the books at the end of the year, the less there is to tax.

One downside to cash-based accounting, then, is that the practice doesn't build up much working capital over time. Another is that the practice's worth can fluctuate wildly. You may start the week flush with money and then pay your bills on Wednesday and your staff on Friday and all of a sudden, the money's gone

Accrual-based accounting prevents this fluctuation. In simplest terms, it tells you what you've earned, not what you've collected. It also allows for the possibility of building up *retained earnings* – a reserve that could be tapped for big capital expenditures. The downside is that you can end up paying taxes on money that hasn't yet been collected.

While most small practices use cash-based accounting, most businesses and most larger health care organizations use accrual-based accounting. It's important to be familiar with accrual-based accounting for several reasons. For one thing, the more practice you have reading accrual-based financial statements, the easier it will be for you to interpret financial statements issued by a hospital or a large entity. But more than that, accrual-based accounting will give you a more accurate picture of the worth of practice assets. It will also give the bank a more accurate picture should you decide to go to them for a loan or a line of credit. Banks generally prefer that your accounts receivable, accounts payable, assets and inventory are calculated using accrual accounting.

The balance sheet also shows that Hometown Family Medicine Group has improved its financial condition by putting more of its cash to work during 2000. In fact, the balance sheet tells us exactly how they did it. The practice improved its collections and reinvested that money in new furniture or equipment. How do we know? Take a look at how assets have been reallocated from 1999 to 2000. Accounts receivable dropped more than $20,000, presumably bringing that much more cash into the practice, and the amount on the "Buildings, furniture and equipment" line increased approximately $15,500. With that additional cash turned into long-term assets, it stands to reason that the practice's current ratio for 2000 will have decreased from the 1999 figure. Try calculating the current ratio for 1999 and see what you get.

Solvency is a measure of your borrowing power to finance economic expansion or to weather an economic downturn. It is calculated using the *debt-to-equity ratio* (total liabilities divided by total equity). Most banks prefer a debt-to-equity ratio of less than 3 to 1. This means that for every $3 in debt, a practice has $1 in equity (owner's money). When a medical practice's ratio gets as high as 3 to 1, banks generally won't lend the practice any more money without the owners securing the loan by signing a personal guarantee.

Looking at Hometown Family Medicine Group's balance sheet for Dec. 31, 2000, we see total liabilities of $40,455 and total equity of $77,969. That gives them a debt-to-equity ratio of 0.519 to 1; in other words, the practice has about $.52 in liabilities for every $1 in equity:

$$\frac{\text{Total Liabilities}}{\text{Total Equity}} = \frac{\$40{,}455}{\$77{,}969} = \$0.52$$

As previously mentioned, most banks prefer a ratio of no more than 3 to 1. At a ratio of .52 to 1, Hometown Family Medicine Group is in a good position to borrow more money. How much more? If banks will lend up to $3 for every $1 in equity, then the practice can carry a total liability as high as $233,907 (3 times $77,969) times the number of FTE physicians (remember, this balance sheet gives all figures per FTE physician). Since the practice already has liabilities of $40,455, it can borrow an additional $193,452 ($233,907 minus $40,455) per FTE physician.

BASIC ACCOUNTING EQUATIONS

The following equations are useful for tracking your practice's performance and comparing it to industry benchmarks. The actual numbers you'll use in these equations are found on your balance sheet. The first three equations are discussed in the article.

Assets = Total Liabilities + Shareholder Equity*

Current Ratio = Current Assets / Current Liabilities

Debt-to-Equity Ratio = Total Liabilities / Shareholder Equity*

Working Capital = Current Assets – Current Liabilities

Percent Debt = Total Liabilities / Total Assets

* Referred to as *fund balances* in a nonprofit organization

Caveat

Given the "Total assets" line on your balance sheet, you may be tempted to use the balance sheet as a convenient statement of the worth of your practice. It's not. It shows what assets cost when they were purchased minus the tax depreciation taken since then. It does not show what they are worth today, and it doesn't factor in goodwill, if any. For practice valuation, you'd need an appraiser.

How often should you review your balance sheet?

Most people review their balance sheets annually, which is fine if you're in an established practice and the economy is generally stable. But if your practice is new or if it's experiencing liquidity problems, you should look at your balance sheet more frequently. In fact, you may want to take several "snapshots" throughout the year (perhaps quarterly) and compare them. It may cost you a little more to have your accountant provide you with quarterly balance sheets, but they're not difficult to produce. Just ask.

Finally, since it generally takes a long time to feel comfortable analyzing financial statements, it makes good sense to sit down with your bank officer or accountant and ask for an explanation of what he or she sees in your practice's balance sheet. It's also an opportune time to discuss your plans for the practice. In all likelihood, you'll find that both your accountant and your banker are eager to help you with the numbers and will work with you so that you can get where you want to go. FM

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To measure a practice's liquidity, calculate the current ratio. To do this, divide current assets by current liabilities.

To measure a practice's solvency, calculate the debt-to-equity ratio. To do this, divide total liabilities by total equity.

A balance sheet shows you what assets cost when they were purchased (less depreciation). To determine a practice's current worth you'll need an appraiser.

It will take a while to get comfortable reading a balance sheet, so don't hesitate to ask your banker or accountant to go over yours with you.