WHY A MEDICAL PRACTICE IS CONSIDERED A FINANCIAL ASSET?

A medical practice is a valuable asset in two respects. First, it provides the work environment that generates your personal income. Second, it has inherent sale value that can be part of an exit (retirement) or transfer strategy. Some of this inherent value lies in the current market value of medical equipment, minus any money owed. The other aspect of inherent value is goodwill, or the worth of the practice as an ongoing concern that allows you to sell it to another practitioner.

WHAT ARE THE COLLABORATORIAL OR NON-FINANCIAL BENEFITS OF AN EFFICIENT PRACTICE?

The rewards of a well-run practice transcend financial considerations. Other benefits include:

1) A better, more consistent clinical result.
2) Improved patient perception which increases referrals and decreases liability
3) Less employee turnover.
4) Less stress.
5) More free time for the practitioner.

WHAT ARE THE FOUR FINANCIAL STATEMENTS?

1. Balance Sheet
2. Income Statement
3. Cash Flow Statement
4. Statement of Retained Earnings
WHY ARE FINANCIAL STATEMENT SOMETIMES CONSIDERED SUSPECT?

Financial statements have potential problems, and are often suspect for several reasons:

1) First they rely on unverified information from the practitioner. A practice’s internal bookkeeping, even with the highest of intentions, is often sloppier than an accountant might hope. Professional liability with the IRS, and time constraints, keep the average accountant from doing anything but merely compiling figures given them. The standard disclaimer on their financial statements states this fact.

2) Most accountants are generalists in that they service other industries, like hog farms and flower shops, besides health care. Specialization developed in health care for a good reason: it became too complex for a single person to have a comprehensive grasp on all of it. The accounting industry has not followed suite. Thus, they often have little direct experience in the health care profession.

3) Accountants generally limit their scope of service to interfacing with the government for you, on tax issues. Thus, their statements reflect tax position, which is only one component of the practice’s total financial condition. While important, this is hardly all your accountant is capable of.

WHAT IS AN INCOME STATEMENT?

The Income Statement (Profit and Loss Statement) reports what income came in, what expenses occurred, and the difference between them, within a specific time period. The most common use for this statement is the “bottom line”, or net profit, for tax purposes. Net profit usually does not equal cash flow. Non-cash conventions, most notably depreciation, required by the IRS, almost always make the “paper” profit different from the “checking account” profit.

WHY IS THE INCOME STATEMENT OFTEN DIFFICULT TO INTERPRET?

The main interpretation issue here is depreciation, and its relative, amortization. Depreciation merely takes the cost of a tangible asset, like equipment, and divides this expense into the successive time periods over which the asset is expected to help produce income. Logically, if you’re trying to figure up true practice costs, a piece of durable equipment often helps produce income long after it was purchased.

WHAT IS AMORTIZATION?

Amortization is the same concept as depreciation but it applies to intangible assets, like medical practice goodwill.
WHAT IS GOODWILL?

Goodwill is basically the value of a medical practice as a going concern minus the book value of the assets. In a mature practice, where accumulated depreciation has decreased the book value of the assets below true market value, and, the reputation of the clinic allows selling it for a premium price, goodwill can be considerable but not reflected in the balance sheet.

WHAT ARE THE METHODS OF DEPRECIATION?

Generally, practice financial statements use the depreciation methods and time frames allowed by the IRS. These have no relationship to the true life span and productivity of the item. For example, purchases of furniture, fixtures, machinery, equipment and other personal property are not expensed, or deducted, when purchased. Rather, the medical business entity is required to capitalize and depreciate these assets over their useful lives. The Internal Revenue Code of 1986 provides asset lives to be used for tax purposes. The listing below is not all-inclusive, but is representative of the most often used Modified Accelerated Cost Recovery System (“MACRS”) asset class lives.

<table>
<thead>
<tr>
<th>Type of Asset</th>
<th>MACRS Depreciable life in Years (in general)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer software purchased</td>
<td>3</td>
</tr>
<tr>
<td>Computers and peripherals</td>
<td>5</td>
</tr>
<tr>
<td>Office machinery and equipment</td>
<td>5</td>
</tr>
<tr>
<td>Furniture and fixtures</td>
<td>7</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>39</td>
</tr>
<tr>
<td>Real office property, non-residential</td>
<td>39</td>
</tr>
</tbody>
</table>

For internal managerial purposes you can assign your own type, and duration, of depreciation. The dual bookkeeping is often worthwhile. The actual cost of the equipment is reflected on the balance sheet.

WHAT IS INTERNAL REVENUE CODE SECTION §179

IRC § 179 allows a business entity to expense a certain amount of asset purchases each year that would otherwise have to be depreciated over their tax lives. This deduction is available for tangible personal property only, not real estate or leasehold improvements, and is a big benefit to most medical practices. This election is available for qualified asset acquisitions up to $128,000 during the 2008 year. It will be $128,000 plus COLA in 2009 and 2010.

The deduction is reduced dollar for dollar for each dollar of acquisitions in a year over the threshold. Also, the depreciation expense created by this election cannot create or increase a tax loss for the practice. Any amount unable to be used in the current period can be carried forward to future periods to offset income in those periods.
WHAT ARE THE THREE METHODS OF ACCOUNTING?

1) **Cash method.** Here, money is counted only as you deposit it, and “spent” only when write a check. Simplistic, but intuitively obvious, this resembles your check register. Unfortunately, the true cash flow method is seldom seen. Most accountants use a tax-modified version of the cash flow method, as required by the IRS for tax reporting purposes.

2) **Accrual method.** Here, income is counted as you earn it, so your accounts receivable is counted as income when you treat patients, despite receiving no cash for it as yet. Expenses get entered as you incur them. In other words you enter a supply order as an expense as it’s placed, not just when you pay for it. This method affords logical treatment of a wider variety of accounting issues than does the cash method and the IRS requires it once certain criteria are met.

3) **Modified cash (tax) method.** This is the cash method modified by depreciation and amortization as required by the IRS.

HOW IS GOOD WILL AMORTIZED USING IRS SECTION §197?

In many cases, the hard assets (furniture, fixtures and equipment) obtained in a medical practice purchase make up only a small portion of the total purchase price. At least part of the price will be allocated to “goodwill”. Goodwill, or “blue sky” as it has also been called, is a premium paid for the reputation of the doctor or the practice entity, or other intangible assets (restrictive covenants) identified within the medical entity. This goodwill, along with most other intangible assets, is amortizable over 15 years using the “straight line” method (IRC Section §197). The straight-line method is a ratable method calculated by dividing the asset’s value by 180 months (15 years x 12 months). The importance of the asset allocation between asset classes becomes evident at this point since most other assets can be depreciated over much shorter periods of time, thus providing larger annual deductions to the practice. It is preferred to allocate as much of the purchase price as reasonably possible to assets that can be depreciated over shorter periods of time.

WHAT IS THE MAIN LIMITATION OF THE INCOME STATEMENT?

The most common significant limitation of the accountant rendered income statement, even with trained interpretation, is poor classification and categorization. For tax purposes, many types of expenses can be grouped together and still render a correct net profit figure.

For example, $500 in seminar tuition that is misclassified as medical supplies expense still renders the correct bottom line but states-states expense in two very different categories. Budgeting and cash flow forecasts may be adversely affected.

It is common to see income statements that categorize expenses into illogical groups. For example, all forms of insurance expense may be grouped together. Yet auto insurance probably belongs with other auto expenses. Workman’s Compensation insurance is actually a payroll expense. Building liability insurance probably belongs with the other premise(s) figures. Using a single insurance category essentially understates all these other expenses and there may not be time, interest or ability to reallocate the insurance expenses more logically.
WHAT IS PHANTOM NET INCOME?

Many medical practitioners wonder where all that net income his account says he made - actually is. Most times a true “cash” net profit never existed, as it was only a phantom accounting artifice for tax purposes. Depreciation often causes discrepancies between “check book” profit, which is how much cash you actually have left over after paying the bills, and taxable income.

WHY DOES ILLLOGICAL CATEGORIZATION OF AN INCOME STATEMENT OCCUR?

Illogical categorization may occur because 1) the accountant does not understand your practice 2) cannot or will not customize the accounts, or 3) the accountant is only interested in the tax implications, or 4) has encountered a lack of proactive input from the practitioner. Furthermore, if you have the accountant enter your checks into a software program, additional blending of categories can occur as low-level employees incorrectly key in your information. Such “blending” of categories negates an opportunity to objectively see where all the money goes.

WHAT IS THE BALANCE SHEET?

The Balance Sheet gives a “snapshot” of the practice at a specific point in time. This timing is different than the Income Statement that uses a period of time. The balance sheet uses the formula: Assets (what you own) equal Liabilities (what you owe) plus Owner’s Equity (what you have left).

WHAT IS THE ASSET BALANCE SHEET CATEGORIZATION DILEMA?

Assets are usually combined into groups, so that a single asset can be evaluated only by examining the accountant’s work papers, and not how they actually are combined in a medical practice. Second, these groupings originate to suite the accountant’s software which results in categorization different than the way the practitioner thinks of the assets.

WHAT IS THE ASSET VALUATION BALANCE SHEET VALUATION DILEMA?

Commonly, balance sheets reflect “book” or “tax” value of assets. This is the historical value (what you paid), minus what you wrote off (depreciated or amortized) for tax purposes. Let’s use equipment bought three years ago for $10,000. For tax purposes, the government forces you to deduct this expense over five years. Thus, for the last three years you depreciated (wrote off/deducted) $2000 on your taxes [10,000/5], for a total of $6000 [(10,000/5) x 3]. The current book or tax value reflected on the balance sheet is $4000 (10,000-6,000). Note this probably does not match the current market value of the equipment.
WHAT IS THE BOOK VALUE BALANCE SHEET DILEMMA?

The Book (tax) value of a medical practice is not immediately apparent because the historical price is listed in the asset section of the balance sheet followed by an entry labeled “accumulated depreciation”. Sometimes the math is a bit more difficult to follow because book value and historical value may have no relation to the true current market value of the asset.

For example, a piece of land you paid $100,000 stays on the books as $100,000 despite the fact the neighborhood has eroded it to $75,000, or conversely, escalated it $125,000. The resulting $25,000 gain or loss is never reflected in the balance sheet. A 20 year old building may have a book value of $49,000 ($100,000 purchase price minus accumulated depreciation of $51,000), but is really worth $110,000 in the current market. With buildings, improvements are not listed in the value of the building, making interpretation even more difficult.

WHAT IS A STATEMENT OF CASH FLOWS?

The Statement of Cash Flows reconciles the change in financial position between two balance sheets. Opinions vary, but it is the least useful to the average practitioner.

WHAT IS A FINANCIAL RATIO?

Financial ratios are figures or percentages derived from components of the financial statements. Even with the inherent limitations, financial ratios are the cornerstone of interpreting financial statements. They are being increasingly used by external sources to value and evaluate medical practices. These financial ratio values are then “benchmarked” to values obtained by surveys which become “industry standard”.

WHAT ARE THE FOUR MAIN FINANCIAL RATIO CLASSIFICATIONS?

Financial ratios fall into four main classifications: 1) liquidity and solvency; 2) asset management; 3) debt management, and 4) profitability ratios.

WHAT ARE LIQUIDITY AND SOLVENCY FINANCIAL RATIOS?

The two most useful are the: Current Ratio and the Current Liabilities to Net Worth.

Current Ratio:

\[
\frac{\text{Current Assets}}{\text{Current Liabilities}} = \text{Current Ratio}
\]
The **Current Ratio** measures short-term solvency. Unfortunately, practice financial statements often do not segregate out current and long-term assets and liabilities accurately. Current assets include cash on hand, the percentage of accounts receivable you can reasonably expect to collect, and short-term investments like a 3-month CD. Current liabilities are notes payable and loans due within one year.

This ratio should be at least one, preferably higher. A banker or venture capitalist probably wants to see this be in the range of about 1.3 to 1.5.

Short-term solvency has an impact on the ability to pay current obligations, which dramatically affects credit, which is an essential tool to controlling practice expenses. Thus, it is an important figure to track internally over time. Establish your definitions that allow consistent calculation of the Current Ratio.

For example, if you enter gross fees into accounts receivable and then adjust off for contractual write off and bad debt, use the last six month’s figures of these adjustments to establish the true eventual cash value of your accounts receivable.

**Current Liabilities to Net Worth:**

Current Liabilities  
___________________  =  Current Liabilities to Net Worth  
Net Worth

This should be low, probably beneath .5, but not zero. Net worth, or owner’s equity, is often distorted on the financial statements, as most practitioners take out all the money “left over” as salary or distributions. This can be especially true if the practitioner holds major assets personally, like the building (a common scenario), and “leases” them to the practice. Bankers circumvent this by evaluating the practitioner and practice simultaneously.

**WHAT IS ASSET MANAGEMENT FINANCIAL RATIOS:**

The four most important are the: 1) Average Collection Period, 2) Fixed Assets Utilization, 3) Fixed Assets to Net Worth, and 4) Total Assets Utilization ratio.

**Average Collection Period:**

Total Accounts Receivable  
_________________________  =  Average Collection Period  
Average Daily Charges (those not collected on the day of service)

The acceptable figure depends on the type of practice. A practice that handles a lot of personal injury cases has a higher number than one that deals mostly in cash. Note that the total accounts receivable is inherently over valued if it includes eventual contractual write off and bad debt. Average daily charges would very on the time period sampled and can be difficult to obtain. This is a vital practice parameter however, and, it is well worth setting up the process to obtain and track the required figures.
Tracked over time (see the later section on trend graph analysis), it provides essential monitoring of the entire collections and billing process. For internal managerial purposes, the top dollar, third party payer components should be tracked individually as the aggregate figure may not immediately detect a rapid change in a single insurance company.

Each extra day of this parameter means someone else is enjoying the float or interest on your money for an additional day. 10 extra days of $50,000 in accounts receivable means at least an additional expense to you of $120 a year, if you could have banked this at 8% APR. Since a practice with protracted collections usually has cash flow problems, this probably translates out to $270 if you’re borrowing money at 18% APR.

**Fixed Assets Utilization:**

\[
\frac{\text{Net Revenue}}{\text{Net Fixed Assets}} = \text{Fixed Assets Utilization}
\]

This shows how productively a practice utilizes its assets. Obviously, you would like any asset you invest in to render as much as possible in additional revenue. Asset evaluation issues (like accumulated depreciation described above) and true practice assets being held by the practitioner for tax purposes, make the managerial use of this figure marginal.

**Fixed Assets to Net Worth:**

\[
\frac{\text{Fixed Assets}}{\text{Net Worth (Doctor owner’s equity)}} = \text{Fixed Assets to Net Worth}
\]

A higher ratio indicates a greater investment in fixed assets which, conversely, may indicate low working capital. This is a great concept in publicly held companies with strict accounting, but less useful to the average practitioner. See the potential problems of fixed asset evaluation (and ownership), and net worth described above.

**Total Assets Utilization:**

\[
\frac{\text{Net Revenue}}{\text{Total Assets}} = \text{Total Assets Utilization}
\]

This is similar to the Fixed Assets to Net Worth described above, but eliminates some of the asset evaluation problems. If the proper definitions are consistently employed, this is a good figure to track internally over time. An example of an appropriate definition might be any asset originally costing over $250 that is in current use, including any held “artificially” by the practitioner for tax purposes. While a “soft” figure, it has value as an indicator of productivity.
WHAT ARE SOME MEDICAL PRACTICE DEBT MANAGEMENT RATIOS?

The two most common are: 1) Total Debt to Total Assets and, 2) Total Liabilities to Net Worth.

**Total Debt to Total Assets:**

\[
\text{Total Debt} \quad \frac{\text{Total Debt}}{\text{Total Assets}} = \text{Total Debt to Total Assets}
\]

Obviously, less debt is generally preferable, so this ratio should be low. Remember debt can be a useful managerial tool if used wisely, and a Total Debt to Total Assets figure of zero might have negative implications. A banker looks for a low figure since he is being asked to provide more debt and wants to ensure his investment.

**Total Liabilities to Net Worth:**

\[
\text{Total Liabilities} \quad \frac{\text{Total Liabilities}}{\text{Net Worth}} = \text{Total Liabilities to Net Worth}
\]

This can be a useful figure if appropriate definitions are used and some practitioners track this internally. Generally, a lower is better.

WHAT ARE THE PROFITABILITY RATIOS?

These include: 1) Profit Margin and 2) Return on Investment Ratios

**Profit Margin:**

\[
\text{Net Income} \quad \frac{\text{Net Income}}{\text{Net Revenue}} = \text{Profit Margin}
\]

Generally expressed as a percentage this figure reflects how much profit the practice makes on each dollar of revenue, usually gross fees. When the practitioner’s salary encompasses “what’s left over” this is zero. For internal purposes it can be considered as potential practitioner salary over gross fees. Obviously, higher is better.
Return on Investment:

\[
\frac{\text{Net Income}}{\text{Total Assets}} = \text{Return on Investment}
\]

This reflects how well assets are used to generate net income. Again, one would strive to make the most money with a given asset, making this figure as high as possible. This concept appears in a break even analysis where the expected return on investment on an individual asset is calculated before buying it.

Sometimes it makes sense to refer potential gross fees to outside sources, despite inherent clinical expertise, because of the equipment cost involved. Other times, traditionally outsourced services now performed in-house help the practice.

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