Give Your Practice a Financial Check-up

by Corporate Relations and Business Strategy Staff

A basic analysis of financial data helps you track the performance of your practice and implement strategies for a sound financial future. This article describes key ratios and indicators to help you begin the process.

Some practitioners are more familiar with financial terminology than others. You may find it helpful to consult a glossary of relevant terms as you read this article. And though the subject of finances is tedious for many health professionals, it's crucial be informed and to monitor the financial pulse of your practice.

Begin by gathering your financial statements including balance sheets and income statements for the past three years. Once you have compiled this information:

- Calculate the financial ratios listed below for each year. (You may want to use a different time interval, such as monthly or quarterly, if that works better for you based on your bookkeeping system and available financial statements.)

- Look for changes and trends, both positive and negative. Have the values gotten better or worse? Sometimes trends are easier to identify visually, so it may be helpful to plot these data points on a graph.

- Try to determine the cause of each change. Were the changes planned or expected, or do they come as a surprise?

- Pinpoint indicators that look problematic and think about how can you address these problem areas and make improvements. You may wish to consult with your financial advisors(s) in this regard.

KEY FINANCIAL RATIOS

Financial ratio analysis uses data from financial statements to help you measure your practice's financial performance. There are many different ratios you can calculate, depending upon your need and the nature of your practice. The main categories and a few examples of each are listed below.

You may generate the following ratios on your own, or ask your accountant to calculate them for you. For those who use financial software such as Quicken or Microsoft Money to help manage their bookkeeping, such software can easily calculate some or all of the following indicators.

Profitability Ratios -- an overall measure of financial performance

Total Margin (also known as profit margin): Measures your ability to control expenses and tells you how much money you actually keep for each dollar that comes in. For example, a Total Margin of 0.17 indicates that for every dollar of revenue earned, you kept 17 cents. You can improve your Total Margin by increasing rates, reducing costs, or increasing your non-operating revenue. The higher your Total Margin, the better.
Total Margin = Net Income ÷ Total Revenue

Return on Total Assets (ROA; also known as return on assets):
Measures how productively you are using your assets to generate revenue by

telling you how many cents of profit you generate with each dollar of your assets. A higher ROA means your practice is more productive.

ROA = Net Income ÷ Total Assets

Liquidity Ratios -- your ability to meet your financial obligations

Current Ratio: Measures your ability to pay back your short-term debts by telling you how many dollars you have in current assets for each dollar of current liabilities. A higher Current Ratio is better (i.e., 2.0 or higher).

Current Ratio = Current Assets ÷ Current Liabilities

Days Cash on Hand: Measures your ability to make your payments when they are due by telling you the average number of days worth of expenses can you cover at any given point in time. You want to strike a balance by having enough cash to pay your bills each month and meet any unexpected expenses, but not having so much that you are not utilizing your assets effectively. For example, your may want to invest extra cash in a vehicle that will generate additional income rather than just sitting in your checking account.

Days Cash on Hand = (Cash + Marketable Securities) ÷ [(Expenses – Depreciation – Provision for Uncollectables) ÷ 365]

Debt Management Ratios -- how effectively you use credit and debt to finance your operations

Debt Ratio: Measures the percentage of your practice's total financing that comes from debt. Creditors prefer a lower Debt Ratio and will be more likely to give you a loan or a better rate, since it means less risk for them.

Debt Ratio = Total Liabilities ÷ Total Assets

Debt to Equity Ratio: Measures how much you have on credit for each dollar of equity you have. Creditors also look for a lower Debt to Equity Ratio, since lending you money is less of a financial risk for them if you have more of your own money invested in your practice.

Debt to Equity Ratio = Total Debt ÷ Total Equity

Asset Management Ratios -- how effectively you manage your assets

Total Asset Turnover: Measures how efficiently you are using your assets by telling you the amount of revenue you generate for every dollar of assets. A higher Total Asset Turnover Ratio is generally better, although it is important to strike a balance. Having too many assets reduces your profits, but too few may result in not having enough resources to offer needed services or pursue new sources of revenue.

Total Asset Turnover = Operating Revenue ÷ Total Assets

Days in Accounts Receivable (also known as average collection period): Measures how effective you are in managing your receivables by telling you the average number of days it takes you to collect a payment. Since you want to collect receivables as quickly as possible a smaller value is better.

> Days in Accounts Receivable = Net Accounts Receivable ÷ (Net Client Service Revenue ÷ 365)

Common Size and Percent Change Analyses -- one way to help you track trends over time

> **Common Size Analysis:** Shows you each item on your income statement as a percentage of your total revenues and each item on your balance sheet as a percentage of your total assets. To calculate, divide each income statement item by total revenues and each balance sheet item by total assets.
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> **Percent Change Analysis:** Helps you see what items on your balance sheet and income statement are growing or shrinking and identify potential financial problems that may not be obvious to the naked eye. Calculate percent change year to year for each balance sheet and income statement item.
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> Percent Change = (Year 2 Value – Year 1 Value) ÷ Year 1 Value

As mentioned above, begin your analysis by reviewing three years worth of historical data. Once you've taken this look back, start tracking these indicators on an ongoing basis and continue to monitor the financial health of your practice.

The next issue of PracticeUpdate (8/17/04) will include an article that discusses how to evaluate and utilize operating data such as your mix of services and health insurance payers to improve the financial performance of your practice.