Financial and Accounting Essentials for New Owners and Practice Managers

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Practice Managers who are relatively new to the profession, or who are now beginning to assume responsibilities for the financial management of the practice may not be familiar with the terminology they'll encounter along the way. Questions like the following may sound like a foreign language:

- Where's our P&L?
- What does cash versus accrual mean?
- What's the difference between a debit and a credit?
- Why don't our assets equal our liabilities? Are they supposed to be equal?
- What are the key financial reports we need to review each month?

If you've ever been asked (or asked yourself) these questions and weren't sure of the answers, it's time to get some clarity, elevate your savvy about basic financial and accounting principles, and clear up any misconceptions or confusion you may have about the business side of veterinary practice. Let's start with the three methods of accounting.

Cash

Businesses that use this method of accounting record income when it's actually received and record expenses when they're actually paid (i.e., when cash actually changes hands). If you provide services to a client in June and the client pays the bill at the time of service, the income will be recorded on the practice's June books. If, however, you provide services to a client in June, but the client doesn't pay the bill until July, the income will be recorded on the practice's July books.

A drug invoice received and paid in June will be recorded as an expense on the practice's June books. If, however, the invoice is paid in July, then the expense will be recorded on the practice's July books.

Accrual

Businesses using this method of accounting record income when it is earned and expenses when they're incurred. If you provide services to a client in June, the income will be recorded on the practice's June books regardless of when the client actually pays the bill. Expenses are considered incurred when you commit to the purchase. So if you order and receive drugs in June, you've incurred the expense commitment and will record the expense on the June books.

Hybrid

This is a combination of cash and accrual. Typically, all income is recorded when actually received (i.e., the cash method). All expenses ***except*** inventory items are recorded when actually paid (i.e., the cash method). Invoices related to inventory are recorded using the accrual method. Under the hybrid method, a Cost of Goods Sold (COGS) calculation is completed for tax purposes. The formula to calculate COGS is:

Value of inventory on hand at January 1	$40,000
Plus inventory purchases during the year	$100,000
Minus value of inventory on hand at December 31	($50,000)
Equals COGS	$90,000

The practice also has a specific business structure, or type of business entity. For example:

Sole proprietorship

One-owner business structure that is the simplest and most inexpensive to form and maintain. A Sole Proprietorship uses a 12/31 calendar year-end, reports on the cash or hybrid basis, and files a Schedule C for tax purposes.

Partnership

A business structure with two or more owners (called partners) that is a pass-through entity. The net income earned from the business passes through to the partners, and the partners are taxed individually on their share of the practice income. The practice doesn't pay taxes. The Partnership uses a 12/31 calendar year-end, reports on the cash or hybrid basis, and files a Form 1065 Federal Income Tax Return. The partners receive a Schedule K-1 for their respective share of the net income.

Corporation
A business structure with one or more owners (called shareholders). A corporation is either a C Corporation or an S Corporation.

- **C Corporation –** net income earned in a C Corporation is taxed at both the corporate level and again at the shareholder level when the income is distributed to the owners. This is called double-taxation. C Corporations typically try to avoid the double tax by "zeroing out" the income at the corporate level by increasing expenses at the end of the year. This could take the form of a bonus to the shareholders or the purchase of equipment. C Corporations can use either a 12/31 calendar year-end or a fiscal year-end (for example, January 31, March 31, June 30, etc.) and file on the accrual basis using Form 1120.
- **S Corporation** – pass through entity; the net income earned from the business passes through to the shareholders, and the shareholders are taxed individually on their share of the practice income. The practice doesn't pay taxes. S Corporations file a Form 1120S using the cash or hybrid basis and a 12/31 calendar year-end. The shareholders receive a Schedule K1.

Limited Liability Company or LLC
One or more owners (called members) that is a hybrid, pass-through entity. The members choose to report for tax purposes as either a Sole Proprietorship (for single-member LLCs), a Partnership (for multiple-member LLCs), or a C or S Corporation (for multiple-member LLCs). LLCs report on a 12/31 calendar year-end under the cash or hybrid basis.

You'll need to be familiar with different types of financial statements, financial reports, and accounting terms.

Chart of Accounts (COA)
The list of the assets, liability, equity, revenue, and expense accounts the practice uses. Ideally, a veterinary practice will use a chart of accounts developed for a veterinary practice (versus some other type of business). Many practices use the chart of accounts published by the American Animal Hospital Association.

Balance sheet (BS)
This report shows the financial position of a business at a specific point in time. The accounts included on the BS include assets, liability, and equity accounts. As the name indicates, the report must balance. The sum of the assets must equal the sum of the liability and equity accounts.

Profit and Loss Statement (P&L)
This report shows the financial position of a business over a period of time and calculates the net income or loss for tax purposes. The accounts included on the P&L include revenue and expense accounts. Income minus expenses equals the net income or net loss (if expenses exceed income).

Statement of Cash Flows (SCF)
This report shows all the sources and uses of cash from operations (cash received and cash spent), from investing (equipment purchases), and from financing (bank loans or cash provided/invested by the owner).

Payroll reports
These include employee timesheets/timecards, employee earnings records (pay stubs, pay period reports, monthly/quarterly/annual reports, and quarterly/annual payroll tax reports), and W-2s.

Management statement™ (MS)
A tool designed by Wutchiett Tumblin and Associates to measure cash flow, to develop a budget, and to efficiently measure and analyze the practice's performance each month. The MS is available at www.wellmp.com/management tools/itemP2.

The accounting cycle begins with a source document. Examples of source documents are invoices, checks, cash, or deposit slips. A source document must be recorded in the appropriate journal – the general journal, or cash receipts and disbursements journal. Entries must balance, which means debit entries must have equal and offsetting credit entries.

For example, if the practice deposits in the bank $1,000 from clients for services provided, you'd make the following entry into the cash receipts and disbursements journal:

Debit Cash for $1,000
Credit Fee Income for $1000

If the practice writes a check for $1,500 to a distributor for an invoice that includes $1,000 of drug and $500 of food purchases, you'd make the following entry into the cash receipts and disbursements journal:

Debit Drug Expense for $1,000
Debit Food Expense for $500
Credit Cash for $1,500

The General ledger is a report of the activity and balance in every account. The Trial Balance is a report of the balance in every account that verifies that the books are in balance (i.e., the sum of the debits equals the sum of the credits).

Use the basics above to get started. As you get more familiar with the basics, then take it to the next level by taking some introductory bookkeeping or accounting classes. Elevating your savvy about basic financial and accounting principles and clearing up any misconceptions or confusion you may have about the business side of veterinary practice enhances your contributions to the practice – a win-win for all.