Understanding the Finances of Oncology Practice, Part 1

It's not enough just to take care of patients. Somebody's got to watch the money. That's a fact of practice, whether you just signed an employment contract or you're the senior partner with an oncology group.

Young physicians should learn about the business side of running a practice, even if they are employed with a guaranteed salary, advises Shawna Jarrett, financial director of the six-oncologist Highlands Oncology Group in Fayetteville, AR, and past president of Southern Oncology Association of Practices. "At some point they are going to be [an owner or] a shareholder, or go out on their own," Jarrett points out. "They're going to want to know about the financials for the future—who would want to pay a lot of money to buy into a practice and not know what they're getting into?"

The Physician's Role in Financial Management

Given that a medical practice's financial operations are usually delegated to staff managers, just how does the physician go about monitoring the finances? And how involved should physicians get? "They need to understand where the revenue is coming from—which procedures, which office visits and related services—as well as the cost of providing those services," Jarrett says. "They're going to have to understand the direct and indirect costs associated with each CPT [current procedural terminology] code charged by a physician."

Acknowledging that most physicians lack formal financial management training, Martin Shenk, of Vista Group Consulting in Danville, CA, says that "providing input and asking questions about budgets, capital asset acquisitions, and financial statements are just a few areas where physicians should play an important role in financial management."

In a medium-sized or large practice, typically at least one of the shareholders has the responsibility for thoroughly monitoring practice finances and alerting the board to problems that need action. Stressing that physicians just starting their career will benefit from learning the ins and outs of practice financials, Jarrett advises young oncologists to "spend some time learning at the knee of the person who is the financial partner."

How to Read Financial Statements

Two financial statements are the key indicators of the financial status of a practice: the balance sheet and the income statement. A third standard financial report, the cash flow statement, is used only in accrual-based accounting system, and is therefore more common in large practices and corporations. It takes time to develop an understanding of the implications of these reports and to track trends, but such an understanding will pay dividends throughout your career.

Financial statements are typically organized according to generally accepted accounting principles. These principles are universal among accounting and auditing firms for recording and reporting financial information.

Balance Sheet

The balance sheet shows the overall financial condition of the practice—what it owns, and what it owes. It presents the practice's financial position at a given point in time, such as the end of a month, a quarter, or a year. It lists the practice's assets, liabilities, and owners' equity.

Assets. Assets represent the wealth owned by the practice, and, according to generally accepted accounting principles, assets on a balance sheet are listed in order of how fast they can be turned into cash. The assets are grouped into current assets, long-term assets, and other assets.

A current asset is anything owned by the practice that could be converted into cash within a year. This would include cash on hand at the office, bank accounts, accounts receivable, and prepaid expenses such as insurance and inventory. Whether accounts receivable are included in assets varies according to the practice's accounting system. If your practice's balance sheet does not list accounts receivable as an asset, it's likely that the practice uses what's called cash-based accounting. See the accompanying box for an explanation of cash-based versus accrual-based accounting.

Long-term assets are items that the practice owns that would typically take longer than a year to convert to cash, such as property—including office furniture, computers, and medical equipment. The accumulated depreciation of these assets, meaning the original cost spread over the years of their estimated useful life, is subtracted from the total value of the assets.

A third category, other assets, includes investments such as stocks, bonds, and joint ventures.

Cash-based versus accrual-based accounting. When a practice or other business is established, it sets up its accounting system to be either cash based or accrual based. With cash-based accounting, transactions aren't logged until the payment is received or the bill is paid. In contrast, with accrual-based accounting, income is put on the books when it is earned (when the patient receives the service, for example), and expenses are recorded when they are incurred, not when the bill is paid.

There are pros and cons to both types of accounting methods because of implications for taxes and cash flow. For tax purposes, cash-basis accounting is favorable because it defers tax obligations until the cash is actually received. For the most part, small practices tend to use cash-based accounting and

larger health care organizations use accrual-based accounting. Cash-based accounting is generally not acceptable for organizations that must make their financial statements publically available.

Some medical practices use a method called modified cash accounting, which combines features of both cash-based and accrual-based accounting.

Liabilities. The liabilities listed on the balance sheet are anything that the practice owes. The practice's liabilities, or financial obligations, are considered claims against the assets. Similar to assets, liabilities are also categorized as either current (those that need to be paid within a year) or noncurrent (those to be paid over a period of more than a year).

Examples of current liabilities are accounts payable (unpaid bills), salaries that are owed, taxes that are due, and accrued retirement plan contributions. Long-term liabilities include loans that are due more than 12 months out.

Equity. The net worth of the practice is shown on the balance sheet under the heading "Equity." The equity represents the amount of money the shareholders in the practice would be left with if all of the assets were liquidated and all of the liabilities were paid off.

The equity might include funds that the original owners put into the practice as an initial investment or buy-ins paid by other shareholders when they joined the practice as partners. In addition, the equity includes earnings the practice has retained over the duration of the practice that has not been distributed to the shareholders.

On the balance sheet, the total of the assets must always equal the sum of liabilities plus owner's equity:

$$\text{Assets} = \text{liabilities} + \text{shareholders' equity}$$

Income Statement

While the balance sheet shows the liquidity and solvency of the practice, profitability is shown by another important report: the income statement. It summarizes and compares revenues with expenses over a short period of time, usually one month, and shows the difference—literally, the bottom line, sometimes called net income or earnings.

The income statement is referred to by numerous other names, including the statement of operations, the profit and loss statement, and the income and expense report.

The income statement is useful for spotting trends from month to month, and also from year to year. The report is especially helpful if it shows current revenue and expenses alongside those of the previous year.

The first part of the income statement will show revenue from patient services and other income such as interest from investments. The second part of the income statement will show, by categories, all expenses paid for the period being

Cash-Based vs. Accrual-Based Accounting

When a practice or other business is established, it sets up its accounting system to be either cash based or accrual based. With cash-based accounting, transactions aren't logged until the payment is received or the bill is paid. In contrast, with accrual-based accounting, income is put on the books when it is earned (when the patient receives the service, for example), and expenses are recorded when they are incurred, not when the bill is paid.

There are pros and cons to both types of accounting methods because of implications for taxes and cash flow. For tax purposes, cash-basis accounting is favorable because it defers tax obligations until the cash is actually received. For the most part, small practices tend to use cash-based accounting and larger health care organizations use accrual-based accounting. Cash-based accounting is generally not acceptable for organizations that must make their financial statements publically available.

Some medical practices use a method called modified cash accounting, which combines features of both cash-based and accrual-based accounting.

reported. Typical expense categories are salaries, benefits, mortgage and other occupancy costs, office supplies, retirement plan contributions, and medical supplies.

Cash Flow Statement

The statement of cash flow reports the flow of cash into and out of a company in a given period of time such as a quarter or a year. It is used only in accrual-based accounting system (see sidebar), and is therefore more common in large practices and corporations.

The cash flow statement provides useful information about an organization's liquidity and solvency in future circumstances, and thus is of special interest to lenders or investors who want a clear picture of the practice's financial outlook. It reports the results of transactions in three categories, and lists them separately:

- Operations—patient services, supplies and drug inventory, payments to employees (salaries and benefits)
- Investing activities—purchasing or selling fixed assets
- Financing activities—money borrowed and outgoing payments on loans, dividends paid to shareholders, proceeds from issuing shares

At the bottom of the cash flow statement the net increase or decrease in cash from all of these categories is shown.

Budgeting

The purpose of an operating budget is to help the practice plan and control expenses and project revenue. "The

oncologists' role in budgeting is to set overall goals such as capital expenditures, physician salaries, and a practice overhead goal," says Shenk. "Once the physicians set the goals, the practice manager or finance director works from there on the specific line items of the budget."

By gathering information from each department about anticipated needs, the financial manager puts together a projection of revenues and expenses for each month of the coming fiscal year. The physicians provide "big picture" input, such as including the purchase of new equipment or the addition a new oncologist. Then the financial manager works out the related expenses. As an example, Jarrett says, "If the physicians wanted to begin doing CBCs in the office, we would budget a capital expenditure to get the equipment in, then we would need to consider related expenses such as an additional staff person to run the tests, and additional supplies."

After the budget is prepared, it can be used to compare actual expenses and revenue to see if the reality is below, above, or at expectations. This comparison is called variance analysis, a helpful report for identifying warning signs of negative trends within the practice. The variance analysis isn't really serving its purpose, though, unless you use it to make necessary changes. For this reason a variance analysis should be reported and reviewed regularly—at least quarterly.

Some practices do not use budgets, but a budget is a very useful tool. It can help a practice control waste, uncover areas of overstaffing or understaffing, monitor overtime, plan for appropriate purchasing, and spot serious problems such as embezzlement.

Pharmaceuticals: Controlling Inventory and Costs

Unlike most other medical specialties, oncology has significant expenses for drugs and related supplies. A 2006 national survey showed that drug expenses average 61% of an oncology practice's expenses in any given year, while in most other medical practices, drugs and supplies are a very small part of overall expenses.^{1,2}

Thus, in oncology practice, good management of drug purchasing and rigorous inventory control is essential for sound financial management. Although the oncologists typically do not get involved in managing the drug inventory, an important role for them is to be sure that a good system is in place. Shenk notes that when a practice is setting up its accounting and office systems, it's important to use a consultant with experience in inventory management and accounting.

For good control of pharmaceutical inventory, Jarrett advises that injection products that are used in high volume be inventoried daily. She adds that she is a big fan of automated inventory systems that communicate directly with the practice

Further Resources

Zeller T, Stanko B, Senagore A (eds): *A Physician's Guide to Financial Statements*. Tampa, FL, American College of Physician Executives, 2002

Stanley KB, Reiboldt JB (eds): *Financial Management of the Medical Practice* (ed 2). Chicago, IL, American Medical Association Press, 2002

Kaufman K (ed): *Best Practice Financial Management: Six Key Concepts for Healthcare Leaders* (ed 3). Chicago, IL, American College of Healthcare Executives, 2006

Wolper L: *Physician Practice Management: Essential Operational and Financial Knowledge*. Sudbury, MA, Jones & Bartlett, 2005

Professional advisors: They're worth it. *J Oncol Pract*, 3:162–166, 2007

management software, so that every drug ordered is automatically billed. In addition, a computerized drug management system provides an inventory report that can be used to compare totals against the physical count.

Oncologists should have a way to review their use of drugs and related supplies. One of the financial reports that the physicians in Jarrett's practice see every month shows the number of new and established patient visits for each physician, the current procedural terminology codes charged by each physician, and the related direct and indirect costs for each service. Reviewing this report can help the physicians see from month to month not only the volume of patient services offered, but also the related revenues and expenses, including drugs and supplies. "In addition," Jarrett says, "they can compare themselves to others. They might notice that they are not seeing as many patients as the average oncologist is—or maybe they're seeing twice as many."

The oncologists in Jarrett's office also receive another useful report related to drug expenses. This quarterly report shows the quarterly average sales price updates from Medicare, reflecting Medicare reimbursement compared with the practice's current costs for each drug.

Seek Outside Help When Needed

In monitoring your practice finances, take advantage of professionals with experience targeted to your needs, especially if your review shows signs of trouble in cash flow or inventory management. Certainly if you are just setting up a practice, financial advisors and practice management consultants are critical in establishing an efficient operation and creating the basic structures for good financial controls.

Jarrett comments that she appreciates having an outside firm prepare the practice's tax returns. "We want that extra set of professional eyes to look at what we're doing, make sure we've done it right, and make suggestions."

Shenk observes that a consultant can be effective in making needed changes. "Consultants can help an established practice improve efficiency because we look at the practice in ways most physicians never have the time or training to do. Once a practice develops a pattern, it's very difficult to break bad habits unless some outside force causes the change.

Consultants are change agents. Most of our ideas are not new or revolutionary, but we fill a need by causing change to happen."

Safeguarding Practice Finances

Finally, be sure that appropriate financial safeguards exist within the practice. Policies and procedures should be in place that protect assets, ensure legal compliance, and reduce the opportunities for errors and fraud. For example, all employees handling cash or accounting records should be bonded, and it's wise to have the practice periodically audited if the finances are not routinely examined in other ways by outside professionals.

Unfortunately, embezzlement and diversion of funds are always a possibility in business—including medical practices. An embezzler often is a trusted employee who has the confidence of the employer. "There are many ways people could find [to divert funds], and the more trust put into someone the more ability he or she would have to do that," comments Jarrett.

Hiring policies should include conducting background checks and obtaining employer references for every employee hired. "This is particularly essential for anyone who will handle money," says Shenk. "In addition, references should always be verified and answers to questions about honesty and integrity should be listened to carefully for what can't be or isn't said."

Segregation of duties is a key element of preventing the opportunity for theft. Handling cash should be totally separated from maintaining records and responding to patient billing inquiries.

One case that Jarrett heard about demonstrates how having one person wear too many hats opens the door for theft. In that practice, the patients' cash payments were being pocketed, and checks from other patients were applied to cover the diversion. The thief was the same person who spoke to patients who called in about their accounts. "If patients called because their statement didn't show a payment they

had made, this person would switch money around again to cover it," Jarrett reports. The scheme was discovered within a couple months, when a patient's call about a missing cash payment went to another employee. Commenting on the pettiness of the operation, Jarrett says, "It was very little money for all the effort put into it and the penalties she faced when caught."

Responsibilities involving money should be segregated among different staff members, but as both Jarrett and Shenk point out, in small practices this can be a challenge. "I always recommend that the front desk money be closed out on some sort of end-of-the-day sheet and turned in to the back office at the end of the day," Shenk says. He also advises that one person be assigned to open the mail, copy and endorse checks, and run a list of the total money received. Then the checks and cash should be turned over to someone else who makes up the bank deposit and takes the money to the bank. The office manager's role is to verify that the total of cash and checks received is the same as the amount posted to accounts receivable that day and that the bank deposit receipt also agrees.

Rotation of job functions and requiring all employees to take vacation time are other advisable policies. Someone who is diverting cash is often reluctant to be away from work because the discrepancies might be discovered by someone covering his or her job.

All checks must be signed by a physician, and a check should never be signed without an attached invoice. Check-signing responsibility may be rotated among group members, and all should take the responsibility seriously. In addition, never provide signed blank checks for the staff to fill in.

Involvement in Finances Will Pay Off

Today's medical environment presents many challenges. Regulatory changes, decreasing reimbursement, managed care demands, and paperwork requirements are just a few of the trials in oncology practice.

Understanding the financial side of practice is critical for physicians to thrive and even survive in this milieu, as Jarrett notes: "Monitoring the financial health of the practice is going to make a huge difference in how successful their practice is going to be—in some cases even if they're going to keep the doors open."

In the next issue of *JOP*, *Strategies of Career Success* will address billing and collections.

DOI: 10.1200/JOP.0836501

References

1. Akscin J, Barr TR, Towle EL: Key practice indicators in office-based oncology practices: 2007 report on 2006 data. *J Oncol Pract*, 3:200-203, 2007

2. Akscin J, Barr TR, Towle EL: Benchmarking practice operations: Results from a survey of office-based oncology practices. *J Oncol Pract*, 3:9-12, 2007