The State of Statements:

Balance Sheets, Income Statements and Statements of Cash Flow

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Introduction

For most audiologists the patient is foremost in mind as we provide hearing care services. Successful practitioners know that when their practice is centered on their patient's welfare, success will usually follow. Probably the greatest responsibility of the patient-centric practitioner is to be in business next year when the patient needs things that are warranty items, or other services that may be of benefit to them. There are many stories of highly suc-

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cessful practices that did not survive for one reason or another. These failures are most commonly related to poor management practices and less likely due to the quality of the clinical care provided.

Historically, academic programs preparing audiologists for clinical work have either not addressed issues of managing a practice as a business entity or have offered limited information as a part of a course rather than offering an entire course in practice management. Contemporary programs are offering comprehensive courses in practice management, increasing the likelihood for not only surviving the first few years of practice but optimizing the chances for success in the hard fought world of today's health care market place. When entering independent, private practice, audiologists must be well prepared to address the multi-faceted challenge that is practice management. They must have the essential tools needed to monitor, manage and maintain their business to profitability. Thus, to be a good manager, clinicians must have the capability to digest information about the financial performance of the practice and develop the background to translate that information into decisions that move the practice toward profitability.

Although it is not necessary to obtain an MBA in order to know how to run your practice or an audiology profit center within a hospital, educational, or other institutional setting, courses in business management, accounting and finance are substantially beneficial and readily available at most local community colleges. These courses offer the practitioner greater insight into the management of their practice and gives them the power to interpret the relevant business variables. The following discussion is an attempt to orient clinicians to the basics of the Balance Sheet, Income Statement and, probably most important, the Statement of Cash Flows.

Financial Statements

Most of us use the services of an accountant to prepare reports and to assist us in the interpretation of the information they contain. Traynor (2008) suggests that practitioners should have knowledge of the vocabulary and language of accounting to effectively communicate with the accounting (and bookkeeping) professionals who manage their practice and protect their assets. Although it is the bookkeeper or office manager in the practice that enters the day-to- day financial data, it is the accountant who prepares financial reports that will assist the practice owner or manager in making evidence-based decisions regarding the success or failure of daily operations, a specific procedure, or a

new market offering. These reports are fundamental to understanding the reasons for positive or negative changes in the bottom-line performance of the practice. Such accounting reports are prepared according to internationally accepted accounting rules called the Generally Accepted Accounting Principles (GAAP), a universal method of valuing profit and measuring assets and liabilities. Although they vary slightly from one country to another, GAAP rules are used to conduct accounting in all businesses. GAAP describes how transactions for costs, profit, inventory, sales and other business specifics are recorded and facilitates a comparison of one business to another since businesses all use these same procedures for accounting. While the role of an accountant in the practice will vary from one practice to another, his or her professional assistance, counsel and guidance of these practitioners is essential to both the long and short term success of the practice.

There are two primary objectives of every business, including audiology practices; profitability and solvency. Unless a practice can produce satisfactory earnings and pay its obligations in a timely manner, all other objectives will never be realized because the practice will not survive. Financial statements that reflect a practice's solvency (the Balance Sheet), its profitability (the Income Statement) and a view of its financial health (the Statement of Cash Flows) provide the practitioner substantive information upon which to make well informed decisions about the operations of the practice. These financial statements are so important that bankers and other lenders depend on them to support their decisions to grant credit opportunities. Bankers and lenders know that financial statements are the bases of the calculations for business ratios that offer important, informative metrics about activity, liquidity, and leverage (debt) of the practice.

Balance Sheet

The Balance Sheet contains the elemental fiscal components of the practice; information about assets, liabilities and owner's equity. It presents a snapshot of the financial condition of the practice at a specific moment in time, usually at the close of an accounting period such as the end of the month, quarter, or year (Brealey et al, 2002). Businesstown.com (2003a) indicates that the purpose of the balance sheet is to quickly review view the financial strength and capabilities of the business as well as answer important questions such as:

- Is the business in a position to expand?
- Can the business easily withstand the normal financial ebbs and flows of revenues and expenses?
- Or should the business take immediate steps to strengthen cash reserves?

The balance sheet gets its name from the fact that the two sides of the statement

Audiology Associates, Inc. Balance Sheet December 31, 2006	
Assets	**Liabilities & Owners' Equity**
Current Assets:	Current Liabilities:
Cash ....34,000.	Short Term Debt..........................20,000.
Accounts Receivable....................80,000.	Accounts Payable....................... 35,000.
Merchandise Inventory.................170,000.	Other Accrued Liabilities.............. 12,000.
Total Current Assets................284,000.	Total Current Liabilities................ 67,000.
Property, Plant and Equipment (Fixed Assets):	Long Term Debt................................ 50,000.
Equipment.............................. 40,000.	Total Liabilities....................... 117,000.
Less Accumulated Depreciation.......................... (4,000.)	Owners' Equity............................ 203,000.
Total Assets..................................320,000.	Total liabilities and Owners' Equity.......................... 320,000.

Table 1: Balance Sheet (Traynor, 2008)

must numerically balance, as presented in the classic formula presented below:

Assets = (Liabilities + Owner's Equity) + (Revenue – Expenses)

Assets are recorded on left side of the Balance Sheet and Liabilities and Owner's (stockholders) Equity are recorded on the right side of the Balance Sheet, as presented in Table 1. Total Assets are set to equal 100 percent, with all other assets listed as a percentage of the total assets. On the right side of the Balance Sheet, Total Liabilities and Equity are also set equal to 100 percent. Entries of all liabilities and owner's (stockholders) equity accounts are also represented as the appropriate percent of the total liabilities and equity. The Balance Sheet must contain all of the practice's financial accounts and should be generated at least once a month. Monthly review of the balance sheet provides a timely, comprehensive overview of the practice's overall financial position at that specific point in time.

Assets listed on the Balance Sheet are items of value that represent the financial resources of the practice. Accounts listed on the Balance Sheet are placed in order of their relative degree of liquidity (ease of convertibility to cash), therefore, Cash is always listed first since it does not require an action or an agent to convert cash into cash. Accounts Receivable is listed second since it represents Cash but must be ìconvertedî into cash by collection. Assets are commonly differentiated into two classes; Current Assets and Fixed or Long-term Assets, see Table 1. Current Assets are short-lived and expected to be converted into cash or to be expended in the operations of the practice within a short period of time, usually within a fiscal year. Current Assets include cash, accounts receivable, product inventory (hearing instrument and assistive listening device inventory, batteries, etc) and prepaid expenses, such as insurance.

Next are the Long-term or Fixed Assets that will not be turned into cash within the practice's fiscal year. Examples of Long-term or Fixed Assets may include, but are not limited to, audiometric and other equipment used in the practice, office equipment and computers, purchased vehicles, purchased buildings, leasehold or tenant improvements, telephone systems. These assets are found in the balance sheet (Table 1) listed as ìProperty, Plant and Equipmentî or as ìFixed Assetsî. To best conceptualize Long-term or Fixed Assets, consider that most fixed assets are purchased over time and must be in place over a long period of time to foster the day-to-day clinical and business operations of the practice. As equipment ages, it is said to depreciate. This depreciation of the equipment is an expense and can be claimed as a tax deduction. The accountant for the practice will evaluate the appropriate method for calculation and the extent of deductions available for every fixed asset listed on the balance sheet.

Liabilities include all obligations the practice has acquired through daily operations of the practice. Liabilities include Accounts Payable (ex. hearing instrument acquisition costs), Accrued Business Expenses, Interest Owed on Loans, and other obligations incurred from daily operations. Owner's or shareholder's equity includes financial investment by the owner or shareholders and the earned profits that are retained in the business. Current liabilities are listed as amounts owed to lenders and suppliers and are usually separated by those that are due in the short term and long term. As with the asset categories, current liabilities are delineated into subcategories such as short term debt, accounts payable and accrued liabilities. These are referred to as current liabilities since they are due to be paid in a short period of time, usually within the fiscal year. A separate category is retained for long term debt, such as bank or other loans payable over a much longer period, usually longer than the fiscal year. All current and long term liability amounts are then totaled collectively to reflect the total liability of the practice (see Table 1). Owner's (shareholder) Equity represents funds that were initially invested by the owner as well as the profit that was earned and retained in the practice.

Income Statement

The Income Statement is sometimes called a profit and loss statement or "P and L" statements and depicts the status of overall profit within the business. McNamara (2007) indicates that income statements simply include how much money has been earned (revenue), subtracts how much money has been spent (expenses) that results in how much money has been made (profits) or lost (deficits). Basically, the statement includes total sales minus total expenses. It presents the nature of the practice's overall profit and loss over a specified period of time. Therefore, the Income Statement gives a practitioner a sense for

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Audiology Associates, INC. Income Statement Year the Ended December 31, 2006	
Net sales	1,200,000.
Costs of goods Sold	850,000.
Net profit	350,000.
Selling, general and administrative expenses	311,000.
Income from operations (EBIT)	39,000.
Interest expense	9,000.
Income before taxes (EBT)	30,000.
Income taxes	12,000.
Net Income	18,000.

Table 2: Income Statement (Traynor, 2008)

how efficiently the business is operating.

In accounting, the practice's profitability is measured by comparing the revenues generated in a given period with the expenses incurred to produce those revenues. The difference between the revenue generated and the expenses created during the generation of the revenue is the profit (or loss) of the practice. In an Audiology practice, revenues are defined as the inflow of revenue from providing patient care or the dispensing of products. Expenses can be considered the sacrifices made or the costs incurred to produce these revenues. If revenues exceed expenses, net earnings result while if expenses exceed net revenue, a loss is recorded.

As with other financial statements, the Income Statement, presented in table 2, may be prepared for any financial reporting period and is used to track revenues and expenses critically important in assessing the operating performance of the practice. Businesstown.com (2003b) suggests that managers can use income statements to find areas of the practice that are over or under budget and identify specific areas of unexpected expenditures. Additionally, the Income Statement tracks the increase or decrease in product returns; cost of goods sold as a percentage of sales and presents some indication of the extent of the practices' income tax liability. Since it is very important to format an Income Statement appropriate to the type of business being conducted, the structure of income statements may vary from one practice to another. In audiology the format may depend upon the mix of business conducted in diagnostics, hearing products, and rehabilitative services.

Net sales on the Income Statement consist of sales figures representing the actual revenue generated by the business. Marshall (2004) states that the Net Sales entry on the Income Statement represents the total amount of all sales less product returns and sales discounts. Directly below the Net Sales in Table 2, is the Cost Of Goods Sold (COGS). COGS are costs directly associated with making and/or acquiring the products. These costs include the acquisition of products, such as hearing aids or assistive devices provided by outside suppliers. If hearing instrument are repaired or manufactured by the practice, COGS could also be materials, parts, and internal expenses related to the manufacturing or repair process, such as faceplates, shells, microphones, receivers, and components.

Net Profit, sometimes called gross profit, is derived by subtracting the cost of goods sold from net sales. This net profit, however, does not include any operating, interest, or income tax expenses. Just below the Net Profit entry in Table 2 is a category for Selling and General Administrative Expenses. This subcategory is described by Tracy (2001) and Marshall (2004) as a broad ìcatch-allî category for all expenses except those reported elsewhere in the Income Statement. Examples of selling and general administrative expenses that are recorded here are legal expenses, the owner's salary, advertising, travel and entertainment, and other similar costs. The actual income from operations, sometimes called Earnings Before Interest and Taxes (EBIT) is the result of deducting the Selling and General Administrative Expenses from the Net Profit. The earnings Before Interest and Taxes (EBIT) are the net revenue generated by the practice. Interest expenses and taxes are subtracted to arrive at the Net Income (or Loss).

Statements of Cash Flow

Statements of Cash Flow reflect the cash position of the practice as well as the sources and uses of cash in the practice during a specified business cycle. It presents how cash flows in and out of the practice. Monthly cash flow statements are useful but quarterly statements of cash flow are essential to provide a look at trends that might be developing in the overall cash-flow picture of the business. Profit and cash-flow are intimately related. A practice can be highly profitable yet on the verge of bankruptcy if the profits are sequestered, for example in the Accounts Receivable—*high profit, low cash flow*. This situation results in limited cash to pay the practitioner, employees and/or to service the accounts payable. Conversely, if there is substantial cash inflow to a practice but excessive overhead costs that are strangling profitability, financial difficulties will ensue—*low profit, high cash flow*. This is a situation where in the practice owner has overextended available resources with ill-conceived equipment purchases, exceptional leasehold costs, or extraneous staff salaries and other questionable business decisions. To illustrate how cash flows in and out of the practice, Marshall (2004) indicates that the Statements of Cash Flow are used to identify the sources and uses of cash over time and

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Audiology Associates, INC.
Statement of Cash Flows
Year the Ended December 31, 2006

Cash Flows from Operating Activities:		
Net income	$ 18,000.	
Add (deduct) items not affecting cash:		
Depreciation expense	4,000.	
Increase in accounts receivable	(80,000.)	
Increase in merchandise inventory	(170,000.)	
Increase in current liabilities	67,000.	
Net cash used by operating activities	$(161,000.)	
Cash Flows from Investment Activities:		
Cash paid for equipment	$ (40,000.)	
Cash Flows from Financing Activities:		
Cash received from issues of long term debt		$ 50,000.
Cash received from sale of common stock		190,000.
Net cash provided by financing activities		$ 240,000.
Net cash increase for the year		$ 39,000.

Table 3: Statement of Cash Flows (Traynor, 2008)

can be compared to the current period for analysis. In Table 3, the cash flow statement is divided into three general sections, Cash Flow From Operating Activities, Cash Flow from Investment Activities and Cash Flow from Financing Activities. The Operating Activity section begins with the Net Income (taken from the Income Statement, Table 2) and includes all transactions and events that are normally entered to determine the operating income. These entries include cash receipts from selling goods or providing services, as well as income earned as interest and dividends, if the practice has investments. Cash Flow From Operating Activities also includes additions or deductions of items affect cash such as depreciation, increase (or decrease) in accounts receivable, merchandise inventory and liabilities, resulting in the Net Cash used by Operating Activities. The Net Amount of Cash Provided (or used) by practice operating activities is the key figure on a Statement of Cash Flows. The Operations Section is of the most interest since it presents the specific areas of the practice where cash was consumed by the running of the practice.

The second section of a Statement of Cash Flows reviews Income generated from investing activities. This section includes transactions and events involving the purchase and sale of equipment, securities, land, buildings, and other assets not generally held in the practice for resale. This area of the statement also covers the making and collecting of loans, if the practice internally finances products and services these loans to consumers internally. Investing Activities are not classified as operating activities since they have an indirect relationship to the central, ongoing operation of the practice. Transactions within the third section record Cash Flows from Financing Activities and deal with the flow of cash between the practice, the owners (stockholders), and creditors as well as the cash proceeds from issuing capital stock or bonds if applicable. For example, if there was a need to transfer profit from the practice to the owners or from the owners (or creditors) into the practice, it would be reflected in the Cash Flows from Financing Activities section. Careful review of the Statement of Cash Flows can offer valuable information to the practitioner as to where the cash generated actually goes and presents an invaluable opportunity to make adjustments in practice operations for management purposes.

Epilogue

Although these statements are extremely useful, as indicated by Freeman (2000), these data are simply numbers. To unlock the real information in these statements, it is necessary to conduct liquidity, activity and leverage (debt) ratio calculations. Although these can be conducted on all of the statements, the ratios of primary importance are conducted on the balance sheet and income statement data. These financial accounting ratios can give the practitioner powerful information about whether there are adequate funds to pay the bills, how long it takes to turn the accounts receivable and provide meaningful information as to the debt of the practice. In the next issue of *Feedback*, the continuation of this topic will discuss the calculation of some important ratios that can influence the management of the practice as they are tracked from month to month, quarter to quarter, and year to year. ■

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