Three Steps to an Effective Practice Budget

By tracking your expenses and comparing them to benchmarks, you can create a practice budget that's useful and easy to maintain.

Keith Borglum

CME Covered in *FPM* Quiz

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"I know I should have a budget for my practice, but I never seem to get around to it." Sound familiar? You're not alone. Many practices never manage to establish a budget, and many others establish a budget and then never look at it again. Unfortunately, it is these practices that practice-management consultants such as myself often get called into when finances go awry, overhead seems too high and there is not enough money left for the physicians at the end of the month. Practices without budgets face a multitude of other problems as well, including embezzlement, over- or understaffing, supply waste, inappropriate purchasing, compensation debates among physicians, inadequate savings for practice improvements and higher-than-necessary income taxes.

ILLUSTRATION BY GREG CLARKE

While budgeting is not typically taught in medical schools or residencies, it's a skill well worth developing. The exercise of creating and maintaining a budget brings a little extra discipline to a physician's business habits, resulting in a healthier practice with fewer unnecessary problems. This article describes three steps you can take to establish an effective budget for your practice.

Step 1: Track expenses appropriately.

Many physicians don't know their costs of doing business, much less what their costs should be. Start by keeping track of what you spend your money on. Fortunately, standards and best practices have already been established for tracking expenses in a medical practice that cover which expenses to track, how to do it and bookkeeping protocols. Also, national statistics on practice overhead can be used to create and modify your budget. Although it's possible to track expenses without using these standards and best practices, if you don't use them you'll have a difficult (or even impossible) time comparing your information to the national statistics. (Note that it's important to designate specifically who will work on the budget before you begin this process. Usually, it works best if a budget is created by the physicians and office manager and maintained by the office manager or bookkeeper through quarterly budget reports and variance analysis, as described in step 3.)

KEY POINTS

- Creating and maintaining a practice budget can bring a little extra discipline to your business habits, resulting in a healthier practice with fewer problems.
- National benchmark statistics on practice overhead can be used to easily create and modify your budget in minutes.
- To make it useful, a budget must be evaluated by performing regular variance analyses.

The first thing you will need to do is decide which expenses to track. A common mistake is to rely on the limited categories of expenses that IRS tax forms and CPAs use to calculate your taxes. A better approach is to create a practice-specific list of expense categories. This list, often referred to as "general ledger categories" or a "chart of accounts," should be as detailed as possible so that useful information can be extracted easily by members of the practice and by an accountant for tax purposes.

The categories in the sample chart of accounts on page 48 are drawn from available standards and benchmarks, but most practices will need to make some changes to tailor it to their own practices. For example, this chart of accounts includes categories for employed, nonowner physicians ("doctor associates") and nonphysician providers, which wouldn't be necessary in every practice. Some practices may wish to further expand the list. For example, a group practice may want to add categories that will allow it to individually track malpractice insurance, staffing or supplies by physician. Or a practice may want to add a temporary category for special events (e.g., relocation, computerization, loss or addition of a provider or disaster recovery) so that statistical anomalies are isolated in the year of occurrence and are less disruptive to future projections.

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In some cases, an expense category may need to appear in two different places on a chart of accounts. For example, in this version, the "marketing: meals and entertainment" category appears under the "general" and "doctor-owner discretionary expenses" headings, since some meals and entertainment may be discretionary and of personal benefit to an owner even though they are also legitimately deductible for tax purposes. Note that discretionary expenses can run as high as 20 percent or more of a physician's income, so it's important to accurately track these.

Combining categories in a chart of accounts is not recommended. A common mistake is to combine clinical and administrative supplies into one category and the compensation and benefits of nonphysician providers or ancillary-revenue-producing paraprofessionals and the compensation and benefits of support staff into another category. These combinations would make it difficult for you to spot theft or embezzlement, identify proper staffing-provider ratios and conduct proper support-staff cost analyses.

Step 2: Use benchmarks to create your budget.

The next step is to use the chart of accounts you've created to establish a budget for your practice. This is typically done by obtaining national or regional family practice overhead statistics for each category in your chart of accounts and then adjusting those benchmarks to suit your practice.

Obtain benchmark data. There are two main sources of family practice cost data: The Medical Group Management Association's (MGMA) *Cost Survey* ($250 for members, $460 for nonmembers; http://www.mgma.com) and the *Statistics Report on Medical and Dental Income and Expense Averages,* which is a joint venture of the National Association of Healthcare Consultants (NAHC), the Society of Medical-Dental Management Consultants and the Academy of Dental CPAs (for a specialty report: $100 for members, $500 for nonmembers; for the full report: $500 for members, $1,500 for nonmembers; http://www.healthcon.org). Both reports include information on staffing counts, accounts-receivable levels and contractual disallowance percentages, and both present data as a percentage of collections (revenue). Having worked with the data

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Practices without budgets face a multitude of problems, including embezzlement, compensation debates among physicians and higher-than-necessary income taxes.

It usually works best if a budget is created by the physicians and office manager and maintained by the office manager or bookkeeper.

The first step to creating an effective practice budget is to start keeping track of your expenses.

Standards and best practices can help you decide which expenses to track and will allow you to compare your information with national statistics.

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Once you've decided what to track, create a "chart of accounts," which is a practice-specific, detailed list of your expense categories.

Next, obtain national benchmark statistics for each category in your chart and then adjust those numbers to suit your practice.

The two main sources of family practice cost data are the *Cost Survey* and the *Statistics Report.*

Adjustments may be needed for a practice with higher-than-average staffing costs, fewer marketing needs, higher rent, etc.

SAMPLE CHART OF ACCOUNTS – VARIANCE ANALYSIS TEMPLATE

This sample chart of accounts incorporates standard expense categories for office-based practices. The online version of this article, available at http://www.aafp.org/fpm/20040100/46thre.html, includes a downloadable Microsoft Excel file that you can tailor to your practice's needs.

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ALL EXPENSES	Budget 100%	This month	Last month	This month last year	This year to date	Last year to date
Capital (IRS section 179) purchases						
Donations and contributions						
Dues						
Fees: Lab						
Fees: Retirement plan						
Insurance: Business						
Insurance: Malpractice						
Janitorial/maintenance						
Journals						
Lease payments: Equipment						
Legal, accounting and consultants						
Loan payments: Principal						
Loan payments: Interest						
Marketing: Ads, promotion and yellow pages						
Marketing: Meals and entertainment						
Meals: Business/staff meetings						
Miscellaneous						
Outside services						
Postage						
Rent and utilities						
Repairs and maintenance: Building						
Repairs and maintenance: Contracts						
Repairs and maintenance: Equipment						
Staff wages						
Staff benefits						
Staff retirement plan						
Staff continuing education						
Supplies: Clinical						
Supplies: Office						
Taxes and licenses						
Telephone/answering service/pager						
Travel and professional meetings						
Uniforms and laundry						
Doctor associate wages						
Doctor associate benefits						
Doctor associate retirement plan						
Doctor associate continuing education						
Ancillary provider wages						
Ancillary provider benefits						
Ancillary provider retirement plan						
Ancillary provider continuing education						
Owner's wages/draws						
Owner's benefits						
Owner's retirement plan						
Owner's auto						
Owner's dues						
Owner's individual and student loans						
Owner's insurances						
Owner's journals						
Owner's marketing: Meals and entertainment						
Owner's other						
Doctor-owner net income (practice profit)						

in both reports for many years, I think the *Statistics Report* is better for the budgeting needs of most private family practices for the following reasons:

• It currently represents 582 family physicians, about 40 expense categories and subcategories by region; includes statistics for physicians with or without obstetrics and in solo or group practice; and has all of its data verified by the submitting accountant or consultant. The *Cost Survey's* last overhead data sampling for non-hospital-owned practices dropped to fewer than 50 practices – each of which has at least three physicians in the group – and has fewer categories and subcategories, with many devoted to staff costs.

A budget serves no purpose if you don't periodically compare your practice's actual finances with your budget and make necessary changes.

• It reports averages rather than medians. The *Cost Survey* reports medians, which tend to dilute the impact of data extremes.

Once you've chosen your source for benchmark data, you'll need to pull out the statistics that match the expense categories listed in your chart of accounts. With these numbers, you can establish a baseline for your budget. It's important to update the benchmark data annually so that your baseline always reflects reality. For example, if the percentage of support staff costs has crept up from the mid-teens to the low 20s over the past decade and you haven't been adjusting your budget accordingly, you could become understaffed and overstressed.

Apply adjustments. Next you'll need to adjust the benchmarks in your baseline to fit your practice. For example, if you use RNs instead of the medical assistants (MAs) referenced in the benchmark data, you would expect to have higher staffing costs than average and would need to adjust the benchmark accordingly. Here's how you would make the adjustment in this example: Multiply the difference between the benchmark MA hourly pay ($10) and your RN hourly pay ($18) by the average work hours in one year (2,076) to figure the extra annual cost of using RNs instead of MAs ($16,608). Then divide the extra annual cost by your average annual practice collections (e.g., $360,000) to figure the percentage increase in your staffing budget (4.6 percent). Finally, add this percentage to the benchmark percentage for MAs (23 percent of collections). In this case, you would set your benchmark with RNs at 27.6 percent.

Other cases where adjustments might be needed are for higher rent if you're in an urban area, lower marketing expenses if your practice is already busy, or higher supply costs if yours is a rural practice or has casting rooms, lab, X-ray, etc. Typically, you need to determine where adjustments are needed only when you are creating your first budget, and then you can simply re-apply the adjustments each year when you obtain the updated benchmark data.

Because your budget is based on annual numbers, this type of adjustment is not necessary for short-term variations that occur because of holidays, physician absences, weather closures, season changes, epidemics and local economic issues. These and other unusual factors, such as posting delays or computer crashes, that push one month's income or expenses into the next month should be noted so that they can be recalled later, but they shouldn't be used to adjust your annual budget. This will allow you to more easily spot any completely unexplained variations that would suggest embezzlement or other problems.

Step 3: Regularly compare your practice's actual finances with your budget.

A budget serves no purpose if you don't periodically compare your practice's actual finances with your budget and make necessary changes. This type of evaluation is referred to as a "variance analysis." In a variance analysis, you look for any numbers in your actual practice finances that vary from the expected norm (your budget), how much they vary and for what reason. Performing this type of analysis and acting on what you learn from it by appropriately directing your attention to a solution is what makes a practice budget useful. (See "A variance analysis" on page 50 for an example of how this type of analysis works.) ➤

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Once you determine where adjustments are needed in your practice, simply reapply the same adjustments each year after you've obtained the annual benchmark data.

Adjustments are not necessary for holidays, physician absences, weather closures, season changes, computer crashes, etc.

You need to periodically compare your practice's actual finances with your budget by performing a variance analysis.

This involves looking for any numbers in your practice's actual finances that vary from your budget, how much they vary and for what reason.

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It's best to perform a variance analysis quarterly so that new problems can be caught quickly.

You should also adjust your budget any time your practice environment changes, such as with a rent or workers' compensation premium increase.

The information obtained from a variance analysis can be used by the practice to appropriately direct its attention toward a solution.

Investing in the effort of budgeting results in a smoother, more profitable and less stressful practice.

For most practices, I recommend performing a variance analysis quarterly so that new problems can be caught quickly. For example, if staff overtime costs are creeping up, you'd want to discover this sooner than the end of the year. However, monthly variance analysis may be too much for most practices since the number of days (and sometimes the number of pay periods) varies each month and irregular payments, such as quarterly, annual and semi-annual payments, may also vary. Quarterly review tends to smooth the monthly statistical variation closer to normal with less false-positives for abnormalities. In addition to the quarterly variance analyses, you should also adjust your budget any time your practice environment changes, such as in the event of a rent increase or workers' compensation premium increase.

As mentioned earlier, it's best if the office manager or bookkeeper prepares these variance analyses. And when an analysis uncovers any statistics that vary significantly from the budget, this person should carefully explain the findings to the physicians. To protect against embezzlement, another staff member, physician or CPA should also occasionally spot-check the work of the person preparing the variance reports.

A smart investment

The bottom line is that investing in the effort of budgeting, just like investing in other good practice-management behavior, results in a smoother, more profitable and less stressful practice. FPM

Send comments to fpmedit@aafp.org.

A VARIANCE ANALYSIS

A "variance analysis" is a regular financial review of your practice in which you look for any numbers in your finances that vary from your budget. Once you find a variance, you determine how much it is, why it's occurring and what you can do to fix it. The following is one practice's financial information after the second quarter of the year. To get an idea of what a variance analysis is like, try to figure out what might have happened in this practice over the last quarter (excluding insurance plan reimbursement delays) just by studying these numbers. (This is just an example. In a real variance analysis, you would look at all the numbers listed in your chart of accounts.)

	Budget	Quarter 1	Quarter 2
Collections	$90,000	$90,000	$75,000
Staffing	23 percent	23 percent	27.6 percent
Rent	6 percent	6 percent	7.2 percent
Medical supplies	4 percent	4 percent	4 percent

Performing a variance analysis on these numbers uncovers the following information:

- Staffing and rent increased as a percentage of collections in the second quarter, but medical supplies remained stable.
- The dollar overhead of staffing remained the same despite lowered collections, which increased the staffing percentage ratio.
- Even though rent is a fixed cost, the percentage went up as collections dropped.
- The medical supplies percentage remained stable, which indicates that fewer supplies were used and fewer patients were seen. This indicates reduced collections *and* reduced productivity. If the problem were just with collections, the chart would also have shown a higher percentage cost of medical supplies.

So, a variance analysis of these statistics would seem to indicate that the reason for the change in costs is reduced productivity (charges) in the second quarter rather than increased overhead. This information can be used by the practice to appropriately direct its attention toward a solution.