A Guide to Understanding an Orthodontic Practice Financial Statement

Barry Oliver

The purpose of this article is to help the orthodontic practitioner have a better understanding of practice financial statements, and what the numbers on these financial statements can tell about the financial condition of the practice. This article explores the basic structure of financial statements, including an analysis of key performance indicators (KPI). Properly analyzing financial statements can give a sense of the health of the practice—pointing out strengths and weaknesses. Not all practices have the same format for their financial statements as others, and statements will vary from practice to practice, some providing more information than others. (Semin Orthod 2011;17:320-331.)

Some practice financial statements provide little, if any, meaningful information to the doctor. This can be the result of a lack of detail, too much detail, or improper grouping of categories. Although there is no one standard in the accounting profession as to how expenses should be grouped and summarized, there are several Certified Public Accountant (CPA) firms across the country that cater to the orthodontic profession. One such organization, the Academy of Dental CPAs (ADCPA; http://www.adcpa.org), is mentioned here because several of the key performance indicators (KPIs) mentioned in this article come from member firms of the ADCPA. Firms that specialize in providing accounting and tax services to orthodontists tend to have a better understanding of how an orthodontic practice operates, and what information is meaningful to help the doctor make important decisions about his or her practice.

In this paper, I will examine the financial statements of an actual practice. The doctor's name has been changed, and a few modifications have been made for clarification purposes only.

The analysis assumes that as a practitioner and businessperson the doctor is motivated by money (that's a good thing, not a bad thing). Otherwise, why would he/she be interested in the financial statements of the practice? It further assumes that the doctor wants to pay the legal minimum in income taxes and retain as much income as possible. In addition, for most practitioners, income taxes are their greatest expense. Most orthodontic practice financial statements are driven by income tax considerations.

The Cover Letter

When a practice receives its financial statements from the accountant, a cover letter will be attached. This is usually referred to as the accountant's compilation report. Figure 1 shows a standard compilation report. The first paragraph clarifies that the statements have been compiled on an income tax basis. This is important because the method of accounting chosen can have a significant impact on how much, and when, income taxes are paid. The income tax basis of accounting for most practices means the same thing as the cash basis of accounting with a few allowances for noncash items. Almost all practices will want to follow this method of accounting to avoid paying taxes sooner than required. The accrual basis

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REAL NUMBERS
REAL IDEAS
REAL PEOPLE

February 15, 2009

Seymour Smiles, D.M.D., Inc.
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We have compiled the accompanying statement of assets, liabilities and equity - income tax basis of Seymour Smiles, D.M.D., Inc., as of December 31, 2008, and 2007, and the related statement of revenues, expenses, and retained earnings - income tax basis, for the quarters and years-to-date then ended, and cash flow - income tax basis, for the year-to-date then ended, and the accompanying supplementary information - income tax basis, which is presented only for supplementary analysis purposes, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the basis of accounting used by the Company for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting in the form of financial statements and supplementary schedules information that is the representation of the owners. We have not audited or reviewed the accompanying financial statements and supplementary schedules and, accordingly, do not express an opinion or any other form of assurance on them.

The owners have elected to omit substantially all of the disclosures, and the statements of cash flows for the quarters ended and the prior year-to-date ordinarily included in financial statements prepared on the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's assets, liabilities, equity, revenues, expenses, and supplementary information. Accordingly, these financial statements are not designed for those who are not informed about such matters.

We are not independent with respect to Seymour Smiles, D.M.D., Inc.

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A PROFESSIONAL CORPORATION

Figure 1. A standard compilation report.

of accounting should generally be avoided for orthodontic practices.

The second and third paragraphs of the compilation report state that the financial statements have not been reviewed or audited, and that the owner of the practice has elected to omit substantially all disclosures. This is important to understand because many doctors think that because their financial statements have been prepared by a CPA, that the CPA will look for and detect fraud and embezzlement. Looking for and detecting fraud or embezzlement is beyond the scope of a standard engagement of compiled financial statements. This is an expensive service, and most practices will not want to incur the significant increase of professional fees to have a review or audit of their financial statements.

Although a discussion about detecting fraud and embezzlement in orthodontic practices is beyond the scope of this article, it is important to understand a few basic areas in which fraud often occurs. As we proceed through the financial statements, areas of vulnerability will also be pointed out.

Statements of Assets, Liabilities, and Equity

Figure 2 shows the statement of assets, liabilities, and equity, commonly known as a balance sheet. Notice the date of the balance sheet is "As of." This means that the balance sheet is as of a point in time, whereas an income statement (to be reviewed next) is for a period, such as a quarter or 3-month period. Not much time is spent analyzing the balance sheet. That's because most doctors want to know how much money they made and the answer to that is found on the income statement, known as net income.

A line by-line analysis of the balance sheet shows that as of December 31, 2008, Dr Smiles had US$104,402 in the bank. Many practitioners manage their practice and measure their success by the amount of cash they have in their bank account. Cash is watched closely by most doctors because of the immediate ongoing need to meet the demands of rent, payroll, supplies, and other operating expenses of the practice.

The next line item is Loan To/from Shareholder of US$48,212. Although shareholder loans are not all that common, they are showing up more frequently, especially for those whose practice legal entity is an S-Corporation. This account usually shows up because the doctor took more money from the practice than there were earnings available, or, if a practice experiences a downturn in production and there is not sufficient cash to pay operating expenses, the doctor sometimes has to put personal funds in to temporarily support the cash account. For inadequate earnings, this becomes an item that is driven mainly for income tax purposes.

Next on the balance sheet is the Property and Equipment, which shows the historical actual dollar cost of fixed assets that are still operating in the practice. This means that Dr Seymour Smiles has spent US$352,203 on things such as furniture, fixtures, dental chairs, computers, phones, etc. Accumulated Depreciation is the amount of fixed assets that has been written off for income tax purposes. There is an additional US$42,199 of write-offs (against income) in the future.

Some doctors have a difficult time understanding how depreciation deductions work for income taxes. For example, let's say the practice purchased US$75,000 of new equipment this year and borrowed US$75,000 on a line of credit to pay for that equipment. Depending on the income tax circumstance, the practice might elect under Section 179 of the Internal Revenue Code to expense off the entire US$75,000 of equipment in year one. That would provide a nice tax reduction in the current year. However, in subsequent years when the line of credit is paid back and cash is flowing out of the practice cash account, there will be no income tax deduction for the cash outlay because the deduction was taken in year one. Conversely, let's assume that instead of writing off the entire amount in year one, the equipment is written off (depreciated) during a 5-year period. Furthermore, let's assume that a 3-year loan was taken out to purchase the equipment. During the next 3 years the cash outlay to pay back the loan would be greater than your income tax deductions because the depreciation (when it is deducted for income taxes) is spread over a 5-year period.

Moving down the balance sheet, we come to the Noncurrent Assets of Goodwill and Patient Records. These assets tell us that Dr Smiles pur-

SEYMOUR SMILES, D.M.D., INC.
STATEMENTS OF ASSETS, LIABILITIES, AND EQUITY
INCOME TAX BASIS
As of December 31, 2008 and 2007

ASSETS

	2008	2007
CURRENT ASSETS		
CASH	$ 104,402	$ 52,709
LOAN TO/FROM SHAREHOLDER	48,212	48,212
PREPAID ITEMS	0	734
Total Current Assets	152,614	101,655
PROPERTY AND EQUIPMENT		
FIXED ASSETS	352,203	323,585
Less: Accumulated Depreciation	(310,004)	(243,420)
Net Property and Equipment	42,199	80,165
NONCURRENT ASSETS		
GOODWILL	250,000	250,000
PATIENT RECORDS	200,000	200,000
Less: Accumulated Amortization	(125,004)	(95,003)
Net NonCurrent Assets	324,996	354,997
TOTAL ASSETS	$ 519,809	$ 536,817

LIABILITIES & STOCKHOLDERS' EQUITY

CURRENT LIABILITIES		
CAPITAL ONE #1068	8,567	0
401-K PLAN PAYABLE	0	2,346
RETIREMENT PLAN PAYABLE	0	39,713
CURRENT PORTION LT DEBT	114,214	108,500
Total Current Liabilities	122,781	150,559
LONG-TERM LIABILITIES		
N/P - HPSC	339,684	448,178
LESS: CURRENT PORTION LT DEBT	(114,214)	(108,500)
Total Long-Term Liabilities	225,470	339,678
TOTAL LIABILITIES	348,251	490,237
STOCKHOLDERS' EQUITY		
PAID IN CAPITAL	6,000	6,000
RETAINED EARNINGS	165,558	40,580
TOTAL STOCKHOLDERS' EQUITY	171,558	46,580
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 519,809	$ 536,817

See Accountants' Compilation Report

Figure 2. Statements of assets, liabilities, and equity.

chased a practice as opposed to starting from scratch because this is the only way you can get Goodwill on your balance sheet. These intangible assets are written off (amortized) for income tax purposes during a 15-year period. Doctors who have purchased Goodwill or other intangible assets know the significance and income tax ramifications of an asset that is written off over a longer period than the loan period used to acquire those assets.

For example, similar to depreciation described previously, let us assume that the doctor borrows money to buy a practice and the loan must be repaid in 7 years. To keep this example simple, let's assume the only assets purchased are Goodwill and Patient Records for US$450,000. These 2 intangible assets would be written off during the course of 15 years, or US$30,000 per year. Monthly payments on a loan of US$450,000, paid back in 7 years, at 7% interest, would be US$6791.71 for an annual total of US$81,500.52. In the later years of the loan, the doctor will probably ask the CPA how come there is so much owed in income taxes but there is very little money in the bank. One answer is because, as one moves to the end of the loan, more of the monthly payment is going towards principal, which is not deductible for income taxes. In year 7, for example, of the US$81,500.52 paid toward the loan, US$78,492.15 is principal whereas the tax deduction is only US$30,000 (the amount one can amortize each year). The good news is that in years 8 through 15 there will be a US$30,000 income tax deduction without any cash outlay. The tough part (for income taxes and cash flow) is making it through the years in which the principal payments exceed the amortization deduction allowed.

The second half of the balance sheet is the liabilities and stockholders' equity section. This section details the amount of practice debt and retained earnings (RET). Under current liabilities it can be seen that Dr Smiles owes US$8,567 on a practice credit card. For the current year the practice is up-to-date and has fully funded the retirement plan obligations so the statement shows that nothing is due at the end of the year. For the previous year, one finds that there are amounts due for the 401(k) and retirement plan. Please note that it is more typical for an amount to be due at the end of the year for the retirement plan because total retirement plan contributions are not usually known until after the end of the year.

Credit card charges is an area in which fraud can easily, and often, take place. If the office manager or other office personnel have access to the doctor's credit card information, the doctor must make a detailed review each month to verify that all charges are authorized and for the business.

The long-term liabilities section shows that Dr Smiles owes US$339,684, which is reduced from US$448,178 a year earlier. The current portion long-term debt is used as a standard in the accounting profession to distinguish debt that is due in <1 year. If the doctor's financial institution is monitoring practice financial statements, the bank will want to know the breakout of long-term and short-term debt.

As we shift to stockholders' equity, the paid in capital represents the amount of money the doctor used from personal funds to begin the corporation. RET represents the amount of practice earnings that have yet to be distributed (or paid out) to the doctor.

Finally, one can see that total assets and total liabilities and stockholders' equity are equal in dollar amount. That is why this is called a "balance sheet." So next time the CPA says "I need to balance the accounts," you will know what the CPA is talking about. Accounts are balanced to ensure that all banking and lending activity in the practice has been accounted for on the financial statements.

Statements of Revenues, Expenses, and Retained or Retained Earnings (RET)

Figure 3 shows supplemental schedules of the statements of revenues, expenses, and RET earnings. The schedule of accounts receivable contains important KPI. As noted previously, this part of the financial statement covers a definitive period. In this example the 2 right-hand columns represent an entire year and the 2 left-hand columns represent the most recent quarter for the years ending December 31, 2008 and 2007. Showing 2 years side by side allows comparisons to be made and see how the practice is doing compared with the previous year for the same period. For this analysis, the term Accounts Receivable has the same meaning as Contracts Receivable. Also notice the left-hand columns represent a quarter or a 3-month period. Some practices like to have their financial statements prepared monthly. However, one should be careful when using 1-month financial statements for key decisions; a practice often has peaks and valleys from month to month, whereas a quarterly statement gives a broader snapshot of the practice.

SEYMOUR SMILES, D.M.D., INC.
STATEMENTS OF REVENUES, EXPENSES & RET. EARNINGS
INCOME TAX BASIS
For the Quarters and Years-To-Date Ended December 31, 2008 and 2007

One Quarter Ended 12/31/08	One Quarter Ended 12/31/07		Four Quarters Ended 12/31/08	Four Quarters Ended 12/31/07
		SUPPLEMENTAL SCHEDULES		
		SCHEDULE OF ACCOUNTS RECEIVABLE		
$ 611,167	$ 468,567	**BEGINNING ACCTS REC**	$ 510,131	$ 397,795
243,580	278,926	CHARGES	1,209,335	1,056,761
243,580	278,926	**Total Charges**	1,209,335	1,056,761
(23,808)	(12,087)	ADJUSTMENTS	(67,673)	(39,706)
(23,808)	(12,087)	**Total Adjustments**	(67,673)	(39,706)
219,772	266,839	NET CHARGES	1,141,662	1,017,055
(254,380)	(225,276)	COLLECTIONS	(1,075,234)	(904,720)
(254,380)	(225,276)	**Total Collections**	(1,075,234)	(904,720)
$ 576,559	$ 510,130	**ENDING ACCTS REC**	$ 576,559	$ 510,130
7.10	**5.49**	***Accts Receivable Ratio***		
		Realization Rate	**94.08%**	**94.33%**
		SCHEDULE OF REVENUE		
254,380	225,276	COLLECTIONS	1,075,234	904,720
0	0	OTHER REVENUES	15	482
0	0	REFUNDS/RETURNED CKS	0	(13,849)
$ 254,380	$ 225,276	**Net Revenues**	$ 1,075,249	$ 891,353

SCHEDULE OF DOCTOR EXPENSES

2,211	0.87%	2,202	0.98%	HEALTH INSURANCE	9,070	0.84%	8,307	0.93%
0	0.00%	1,433	0.64%	DISABILITY INSURANCE	0	0.00%	1,433	0.16%
898	0.35%	878	0.39%	PAYROLL TAXES	9,659	0.90%	9,481	1.06%
525	0.21%	125	0.06%	CONTRIBUTIONS	3,410	0.32%	2,105	0.24%
2,089	0.82%	2,884	1.28%	DUES & SUBSCRIPTIONS	4,608	0.43%	8,360	0.94%
0	0.00%	0	0.00%	TRAVEL & LODGING	857	0.08%	1,101	0.12%
3,084	1.21%	2,407	1.07%	AUTOMOBILE EXPENSE	11,449	1.06%	10,669	1.20%
180	0.07%	240	0.11%	EDUCATION & MEETINGS	300	0.03%	910	0.10%
1,341	0.53%	1,351	0.60%	MEALS & ENTERTAINMENT	5,361	0.50%	5,729	0.64%
$ 10,328	4.06%	$ 11,520	5.13%	**Total Dr. Expenses**	$ 44,714	4.16%	$ 48,095	5.39%

See Accountants' Compilation Report

Figure 3. Supplemental schedules of the statements of revenues, expenses, and RET earnings.

Beginning on January 1, 2008, Dr Smiles had an accounts receivable balance of US$510,131. Charges or production for the year were US$1,209,335 compared with US$1,056,761 for the previous year. Given the economy during 2008, this represents a significant increase in

charges. Adjustments for the year were US$67,673 for total net charges of US$1,141,662. Collections were US$1,075,234 compared with US$904,720 for the previous year. The ending accounts receivable balance at December 31, 2008, was US$576,559. The schedule flows from top to bottom following simple math—beginning accounts receivables plus charges minus adjustments minus collections equals ending accounts receivable.

The first KPI to notice in Fig. 3 is that the practice had an increase of US$124,607 of net charges. Clearly, this is an increase any practice would like to see, especially given how tough the economy was in 2008. The next KPI is the realization rate. For both 2007 and 2008 the realization rate was slightly >94%. The realization rate means that for every dollar in patient charges the doctor is collecting that percentage of charges. In 2008, Dr Smiles collected US$940.80 for every US$1,000 charged. Most practices will be at 95% and above on their realization rate.

Items that affect the realization rate are adjustments that include cash discounts, sibling or family discounts, scheduling discounts, uncollectible accounts, professional discounts to colleagues, or promotional discounts, such as to a staff member of a referring doctor. In these tough economic times many practices have seen their realization rate decrease because of patients who are not able to keep up with their payments for treatment. If the realization rate drops much <95%, one may want to reconsider the financial policies and the credit worthiness of the patients you accept in the practice.

The accounts receivable of the practice is an area ripe for fraud and embezzlement. One should periodically check the adjustments to ensure they are valid. It would be easy for a staff member to collect the payment, post it as an adjustment (as opposed to a payment), then put the check or cash payment into his or her own bank account. Depositing a check made out to the practice into another account of a different name would not be difficult and would most likely go undetected by the bank.

Another KPI on the Fig. 3 schedule is the accounts receivable ratio. This ratio measures the average amount of time it takes to collect (on average) full payment from the time treatment was initiated on a patient. For the period ending December 31, 2008, the accounts receivable ratio for Dr Smiles was 7.10, which means on average that full (treatment) payment is received in just a little over 7 months per patient. It is important to watch this ratio because if the ratio becomes too low, it could be an indication that too many patients are paying up front, taking advantage of a cash discount (that could be too high). One might find that lowering the cash discount will result in more patients using the standard payment plan.

The question comes up why would one not want to have as many (if not all) prepayments as possible? The first obvious answer mentioned previously is that if everybody is prepaying, then the practice's cash discount is probably too high and money is being left on the table. Second, as many practices have experienced in 2008 and 2009, when there is a slowdown in patient starts, and cash flow is not maintaining normal levels from new patients, then a robust Accounts Receivable can sustain the practice until things turn around. Some doctors have said that they prefer the prepayment and if things later slow down they will put money back into the practice to keep it afloat. In theory that line of thinking is fine; however, in reality once money leaves the practice and is paid to the doctor, it is most likely spent and not available for the practice if there is a need.

Statements of Revenues, Expenses, and Retained Earnings

Figure 4 shows a standard profit and loss or income statement. Instead of working from top to bottom, one should first look at the bottom line, operating income (loss) before doctor expenses, and then review from top to bottom. Most doctors are more interested in looking at the bottom line first.

For the 12-month (or 4 quarters ended) period ending December 31, 2008, Dr Smiles had operating income before doctor expenses of US$518,992. This is an increase of US$172,031 from the previous year's operating income of US$346,961. Going to the top line, net revenues, the practice experienced a substantial increase in net revenues of US$183,896 (from US$891,353 to US$1,075,249) for a 20% increase from the previous year.

The first main category of expenses on the income statement is total employee compensation, which consists of salaries for assistants, of-

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STATEMENTS OF REVENUES, EXPENSES & RET. EARNINGS
INCOME TAX BASIS
For the Quarters and Years-To-Date Ended December 31, 2008 and 2007

One Quarter Ended 12/31/08		One Quarter Ended 12/31/07			Four Quarters Ended 12/31/08		Four Quarters Ended 12/31/07	
$ 254,380	100.00%	$ 225,276	100.00	**Net Revenues ***	$ 1,075,249	100.00%	$ 891,353	100.00
				Operating Expenses				
17,205	6.76%	17,719	7.87%	SALARIES - ASSISTANT	66,101	6.15%	64,692	7.26%
22,309	8.77%	33,667	14.94%	SALARIES - OFFICE	110,323	10.26%	114,199	12.81%
0	0.00%	0	0.00%	TEMPORARY LABOR	0	0.00%	0	0.00%
3,023	1.19%	4,060	1.80%	PAYROLL TAXES	16,916	1.57%	16,785	1.88%
8,219	3.23%	16,172	7.18%	EMPLOYEE BENEFITS *	15,565	1.45%	16,172	1.81%
50,756	19.95%	71,618	31.79%	**Total Employee Comp**	208,905	19.43%	211,848	23.77%
9,597	3.77%	6,410	2.85%	RENT	37,860	3.52%	33,965	3.81%
1,000	0.39%	544	0.24%	UTILITIES	3,940	0.37%	3,610	0.41%
250	0.10%	0	0.00%	OTHER TAXES & FEES	1,993	0.19%	4,250	0.48%
6,153	2.42%	8,117	3.60%	INTEREST	27,413	2.55%	36,609	4.11%
9,492	3.73%	13,361	5.93%	DEPRECIATION	37,966	3.53%	53,445	6.00%
7,500	2.95%	7,500	3.33%	AMORTIZATION	30,001	2.79%	30,001	3.37%
8,078	3.18%	5,636	2.50%	DEPRECIATION - SEC. 179	28,618	2.66%	13,249	1.49%
0	0.00%	0	0.00%	EQUIPMENT RENTAL	0	0.00%	0	0.00%
1,761	0.69%	1,324	0.59%	MAINTENANCE *	4,909	0.46%	5,311	0.60%
1,120	0.44%	1,620	0.72%	TELEPHONE	7,656	0.71%	4,033	0.45%
44,951	17.67%	44,512	19.76%	**Total Occupancy Expense**	180,356	16.77%	184,473	20.70%
17,884	7.03%	22,209	9.86%	PROFESSIONAL SUPPLIES	66,860	6.22%	54,539	6.12%
7,266	2.86%	9,231	4.10%	LABORATORY	27,955	2.60%	32,365	3.63%
7,717	3.03%	5,920	2.63%	OFFICE EXPENSE *	29,074	2.70%	20,355	2.28%
32,867	12.92%	37,360	16.58%	**Total Supplies and Laboratory**	123,889	11.52%	107,259	12.03%
2,571	1.01%	2,449	1.09%	MALPRACTICE INSURANCE	2,571	0.24%	2,449	0.27%
(599)	(0.24)%	(3,124)	(1.39)%	OTHER INSURANCE *	4,145	0.39%	440	0.05%
0	0.00%	0	0.00%	CONTRACT SERVICES *	854	0.08%	4,187	0.47%
1,430	0.56%	1,390	0.62%	LEGAL & ACCOUNTING *	10,655	0.99%	9,495	1.07%
0	0.00%	0	0.00%	COLLECTION COSTS	0	0.00%	0	0.00%
2,636	1.04%	1,454	0.65%	MERCHANT FEES	7,718	0.72%	6,324	0.71%
169	0.07%	95	0.04%	UNIFORMS & LAUNDRY	311	0.03%	395	0.04%
0	0.00%	143	0.06%	DUES & SUBSCRIPTIONS	205	0.02%	746	0.08%
5,096	2.00%	2,383	1.06%	MARKETING EXPENSE *	12,000	1.12%	13,480	1.51%
0	0.00%	0	0.00%	TRAVEL & LODGING	0	0.00%	152	0.02%
1,000	0.39%	0	0.00%	EDUCATION & MEETINGS	2,240	0.21%	2,420	0.27%
1,341	0.53%	371	0.16%	MEALS & ENTERTAINMENT	2,162	0.20%	682	0.08%
0	0.00%	0	0.00%	AUTOMOBILE EXPENSE	246	0.02%	42	0.00%
13,644	5.36%	5,161	2.29%	**Total Other Expense**	43,107	4.01%	40,812	4.58%
142,218	55.91%	158,651	70.43%	**Total Expense**	556,257	51.73%	544,392	61.07%
				Operating Income (Loss)				
112,162	44.09%	66,625	29.57%	**Before Doctor Expenses**	518,992	48.27%	346,961	38.93%

See Accountants' Compilation Report

Figure 4. A standard profit and loss or income statement.

fice staff (including the office manager and/or treatment coordinator), temporary labor, payroll taxes, and employee benefits. It will be noticed that the category "employee benefits" has an asterisk (*) symbol by it. Any time this symbol is seen, it means that there is a supplemental schedule that provides greater detail for that category. For this article, the author will not analyze most supplemental schedules but will comment on them as appropriate. For example,

employee benefits generally consist of things such as health insurance, profit-sharing contributions, and flexible spending accounts for employees. No benefits for the doctor owner are included here. By separating out these types of expenses for the doctor, that are considered discretionary and not necessary expenses for running the practice, a clearer picture of true practice overhead is obtained.

One needs to be careful when reviewing total employee compensation to ensure that salary and benefits paid to the doctor's spouse or children are removed from the totals unless, of course, the spouse or children provide services that actually benefit the practice. Otherwise, on a percentage basis, the employee costs will be inflated. A typical practice will have employee costs ranging from 20% to 25% depending on location and benefits offered.

Employee compensation is another area that is oftentimes used to commit fraud. It is easy for hours worked to be overstated. It is also easy for the person in the office who calls in payroll to the payroll service to change the pay rate, which would be difficult for most doctors to detect. Ghost employees (who do not exist) might also be on the payroll. The doctor must be sure to check the employee payroll on a regular basis.

Employee expenses are considered fixed costs. Fixed costs are expenses the practice will incur regardless of practice income. These fixed costs sometimes become stepped fixed costs. As a practice grows and needs more capacity, additional employees are added and results in stepping up the fixed costs of the practice. Conversely, as many practices have experienced a decline in patient starts and revenues this past year, employee costs are stepped down as employee days are cut back and hours are reduced. Because these are fixed costs, their percentage of overhead based on revenue will fall as revenues increase, and employee costs percentage will increase as revenues from the practice decrease.

The next main category shown is total occupancy expense. Occupancy expenses are all the items shown from rent through telephone. A typical practice will have occupancy expenses ranging from 10% to 13%. For rent most practices will range from 6% to 8% or greater if in retail space. Dr Smiles rent expense is 3.52% of net revenues, well below the average practice. This can be because of a favorable lease or a very efficient practice based on the square footage used by the practice. Interest expense is US$27,413 down from US$36,609 in the previous year. This decrease would be expected because as the practice pays off its loan, more of the payments are going towards principal and less is paid for interest on the loan. Depreciation has also declined from the previous period as the practice assets are being written down from year to year. It can be noted that the amortization expense remained the same in both years. This is because the amortization expense relates to the goodwill purchased when Dr Smiles bought the practice. Goodwill is written off on a straight-line basis over 15 years. The Section 179 line shows current year equipment purchases that the doctor has elected to expense off the total purchase at once for tax purposes as opposed to depreciating the purchase amount over a longer period. Occupancy expenses are considered fixed expenses for the practice.

The next category to review is supplies and laboratory, including office expense. These costs are known as variable expenses. Variable expenses should remain consistent on a percentage basis relative to net revenues. In this example, professional supplies for both years hover close to 6% and the laboratory expense is close to 3%. These expenses can vary widely among practices as doctors make individual choices as to the types of brackets (and other professional supplies) purchased, the vendor purchased from, whether the practice does their own laboratory work, and whether the office has a panoramic and cephalometric X-ray machine.

There can also be a wide range in professional supplies and laboratory expenses among practices that provide Invisalign (Align Technology, San Jose, CA), with some not offering it at all and other practices that have a significant portion of their patients using it. In addition, because Invisalign is still relatively new to the profession, there is not consistency among accounting firms, even those who specialize in serving orthodontic practices, as to which category Invisalign costs are assigned to—either professional supplies or laboratory. Many practices are now moving to have a separate line item for Invisalign costs, which is probably how it should be listed for accuracy and clarity. Look for more consistency in this area if more practices offer

Invisalign, or it becomes a more significant part of orthodontists' practices.

Office expense for most practices will range between 2.5% and 3%. Office expense includes miscellaneous office supplies, postage, bank charges, and computer expenses.

The next main category of expenses includes miscellaneous but necessary expenses to run a practice. Contract services might include a management consultant or a professional associate. Merchant fees show the cost incurred when patients use their credit cards or arrange for outside third-party financing. Care should be taken regarding merchant fees because it is easy to not pay attention to them, resulting in paying 2-3 times more than needed. Also, making sure staff members are trained to steer patients to less-expensive outside payment options without losing the patient should be considered. Marketing expense for most practices should be approximately 2%. It can be seen that the categories of education and meetings, meals and entertainment, and automobile expense are not very high in dollar amounts. This is because the expenses on the schedule reflect those relating to staff members and not the doctor owner.

The total expense for the practice is now considered. It can be seen that the practice has overhead of 51.73% down from 61.07% in the previous year. In actual dollars, total expenses only increased by approximately US$12,000. The large decrease in overhead percentage was attributable to increased revenues. Therefore, in most instances the best way to reduce the practice's over-

SEYMOUR SMILES, D.M.D., INC.
STATEMENTS OF REVENUES, EXPENSES & RET. EARNINGS
INCOME TAX BASIS
For the Quarters and Years-To-Date Ended December 31, 2008 and 2007

One Quarter Ended 12/31/08		One Quarter Ended 12/31/07			Four Quarters Ended 12/31/08		Four Quarters Ended 12/31/07	
0	0.00%	0	0.00%	ASSOCIATE FEES	0	0.00%	0	0.00%
61,923	24.34%	60,577	26.89%	SALARY - DR STRAIGHTEETH	230,000	21.39%	224,808	25.22%
10,328	4.06%	11,520	5.11%	DR EXPENSES *	44,714	4.16%	48,095	5.40%
30,500	11.99%	29,541	13.11%	DR RETIREMENT CONTRIBUTION	30,500	2.84%	29,541	3.31%
102,751	40.39%	101,638	45.12%	**Total Doctor Expenses**	305,214	28.39%	302,444	33.93%
97	0.04%	0	0.00%	OTHER INCOME	98	0.01%	0	0.00%
97	0.04%	0	0.00%	**Total Other Income (Loss)**	98	0.01%	0	0.00%
9,508	3.74%	(35,013)	(15.54)	**Net Income (Loss) Before Non-Deductible Items**	213,876	19.89%	44,517	4.99%
0	0.00%	0	0.00%	PENALTIES	0	0.00%	0	0.00%
0	0.00%	0	0.00%	PRIOR PERIOD TAX PYMTS	0	0.00%	0	0.00%
0	0.00%	0	0.00%	FEDERAL INCOME TAXES	0	0.00%	0	0.00%
0	0.00%	0	0.00%	OTHER NON-DEDUCTIBLE ITEMS	0	0.00%	0	0.00%
$ 9,508	3.74%	$ (35,013)	(15.54)	**Net Income (Loss)**	$ 213,876	19.89%	$ 44,517	4.99%
189,706		79,022		**Beginning Retained Earnings**	40,580		1,478	
(33,656)		(3,429)		S-CORP DISTRIBUTIONS	(88,898)		(5,415)	
$ 165,558		$ 40,580		**Ending Retained Earnings**	$ 165,558		$ 40,580	

* Indicates Supplemental Schedule

See Accountants' Compilation Report

Figure 5. The remaining portion of the income statement.

head percentage is to increase the top revenue line. Most practices will find it difficult to reduce overhead in a substantial way without reducing staff or obtaining a rent reduction—expense items that are difficult to run a practice without.

Income Statement Continued

Figure 5 shows the remaining portion of the income statement. It is noted that Dr Smiles took salary during 2008 of US$230,000. In addition, another US$30,500 was put into the practice profit-sharing plan for the doctor. Not shown is the doctor's 401(k) contribution, which is included in the doctor's salary. Doctor expenses of US$44,714 (see Fig. 3) includes items such as payroll taxes on the doctor salary, doctor health insurance, doctor life insurance, doctor disability insurance, doctor automobile expense, meals and entertainment, travel and lodging, continuing education, and other doctor owner expenses that are discretionary in nature and should not be included in determining true practice overhead. Thus, for 2008, Dr Seymour Smiles earned a total of US$474,376, which consisted of his salary of US$230,000, the retirement plan contribution of US$30,500, and the remaining net income of US$213,876.

SEYMOUR SMILES, D.M.D., INC.
STATEMENT OF CASH FLOWS
INCOME TAX BASIS
For the Year-to-Date Ended December 31, 2008

		2008
CASH FLOWS FROM OPERATING ACTIVITIES		
NET INCOME (LOSS)	$	213,876
Adjustments to reconcile Net Income (Loss) to Net Cash provided by (used in) operating activities:		
NET INCREASE (DECREASE) IN DEPRECIATION		96,585
PAYROLL TAX LIABILITIES		0
PREPAID ITEMS		734
SHORT TERM NOTES & CREDIT CARD (BORROWINGS)		104,886
SHORT TERM NOTES & CREDIT CARD (REPAYMENTS)		(96,320)
RETIREMENT PLAN LIABILITIES		(42,059)
Total Adjustments		63,827
Net Cash Provided By (Used in) Operating Activities		277,703
CASH FLOWS FROM INVESTING ACTIVITIES		
NET DECREASE (INCREASE) IN CAPITAL EXPENDITURES		(28,618)
PROCEEDS FROM SALE OF FIXED ASSETS		0
Net Cash Provided By (Used in) Investing Activities		(28,618)
CASH FLOWS FROM FINANCING ACTIVITIES		
LONG TERM NOTES PAYABLE (REPAYMENTS)		(108,494)
SUB-S CORP DISTRIBUTIONS		(88,898)
SHAREHOLDER LOANS		0
PROCEEDS FROM SALE OF STOCK		0
Net Cash Provided By (Used in) Financing Activities		(197,393)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		51,693
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD		52,709
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$	104,402

See Accountants' Compilation Report

Figure 6. The Statement of cash flows.

The Statement of Cash Flows

The statement of cash flows is shown in this article (Fig. 6) not because there is much value to it but because it is a required disclosure that a CPA must include, as part of the accounting profession's standards. This schedule is useful in understanding the difference between cash flow and net income. If the doctor owner has more practice income that required payment of income taxes without having the cash available, this schedule helps to explain and reconcile the difference.

Summary

As is evident, the financial statements can be rather involved. It is critical for an orthodontist to be able to read and understand the information presented in the practice financial statements to be in a position to make adjustments in practice management and/or internal controls. A CPA with a sound understanding of orthodontics can assist the orthodontist in analyzing the financial health of the practice, and advise him or her on potential changes to maximize the practice's bottom line.