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FINANCIAL MANAGEMENT

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THIS CHAPTER WILL INCLUDE A REVIEW OF:

- Drafting a financial plan
- Financing the practice
- Obtaining finance
- Bookkeeping principles
- The accounting process
- Processing documents

INTRODUCTION

While optometrists cannot be expected to have all of the financial and bookkeeping skills and knowledge of an accountant they will, in the interests of due diligence, need a working knowledge. They will also be responsible for much of the data entry that will be accessed by their financial advisors. Nevertheless, while not expected to be experts, optometrists must be able to understand the advice given by their advisors. An optometrist who distances himself or herself from their finances is putting too much trust and power in the hands of others who may not have the same interest in the practice and its success.

DRAFTING A FINANCIAL PLAN

The financial plan is a budget based on expectations of income and expenses. It is used to determine whether the business is viable or not and if viable sets the plan for the expenditure and expected income. A new practice will require start-up capital which must be budgeted for in addition to the budget for the normal income and expenditure.

Financial institutions providing the funding for the practice will normally expect a detailed financial plan as a part of the business plan. They will also expect a detailed explanation of how the optometrist arrived at relevant figures, such as predicted turnover.

The budget will allow more accurate control of the practice. Any changes to either income or expenditure will become apparent to a keen observer and changes in strategy can be put in place to mitigate undesirable effects. This is an essential element of what is referred to in legal terms as due diligence. Due diligence is often used, in its narrower definition, to refer to an audit of a potential investment. Here it is intended to mean a standard of care in monitoring one's own business. There are several steps in drafting a financial plan for a new optometry practice.

DRAFTING A FINANCIAL PLAN(CONT.)

1. Calculate the funds needed to start the business

These funds include all establishment costs such as professional fees for accountants and lawyers, initial lease payments, purchase of stock, and initial lease costs of equipment. It will also include working capital to cover business expenses for at least six months while the patient base is being built. Few practices start with their desired patient numbers in the first few weeks.

There are two types of costs which need to be determined, namely fixed and variable costs.

Fixed costs:

Fixed costs are costs which do not change with changes in income. These include rent, insurance, electricity and salaries. These are relatively easy to determine with a high degree of accuracy.

Variable costs:

Variable costs are costs which change, depending on income. These include the cost of goods sold and telephone expenses. While variable costs will generally be a predictable percentage of income there will be less certainty than with fixed costs. Control of variable costs is a major factor in business success.

2. Calculate the amount to be borrowed by the practice

The amount required to be borrowed will depend on the amount invested by the owner (optometrist). Borrowing funds involves some risk on the part of the optometrist setting up a new practice. The more money that is borrowed, the greater will be the financial risk. The ratio of borrowed funds to owner's equity is referred to as 'gearing' and a high-geared company or business runs a greater risk of financial problems than a low-geared company since a significant amount of the money used to start the business is borrowed and requires repayment. An optometrist intending to open a new practice would be expected to invest a reasonable amount of his or her own money and not rely solely on funds borrowed by the business.

The amount the owner has invested in the practice is referred to as owner's equity. It can be calculated with what is referred to as the accounting equation:

Equity = Assets – liabilities

The figures for the accounting equation are obtained from the balance sheet of the business.

3. Determine the profit required for an adequate return on investment

The profit represents the money earned from the investment. This is money earned in addition to the salary the optometrist should pay him- or herself from the business. The profit should at least compete favourably with other alternative forms of investment such as bonds or shares. If not then the optometrist would be financially better off working for another optometrist and investing his or her money in a higher yield investment.

The average gross profit for the optometry profession in the region if known will give guidance in step 3 above and if not available the optometrist will determine what they would need for an acceptable return. For most professions the expected yield will probably fall within a small range, for example 10% to 15%.

4. Calculate the turnover required to produce the calculated return

This involves working back from the desired return. For example, if the desired return is 15% and $300000 is invested by the owner then the practice must generate profit of $45000 (15% of the $300000 invested). If the expected yield for the practice is 10% then the turnover needed to deliver a profit of $45000 will be $450000. This return on investment is in addition to the salary paid by the optometrist to him or herself. It is important that the optometrist includes his/her own salary as a business cost.

5. Test the feasibility of the calculated turnover

This involves predicting the number of patients and income from eye tests, the proportion of patients who will need and purchase spectacles or contact lenses and the average selling price of spectacles and contact lenses. As an example (we will assume that only spectacles are dispensed); we will assume that eye tests are $50, that 50% of patients order spectacles and that the average selling price of spectacles is $500. Therefore each patient equates to $300 ($50 eye test plus $250, being half of the average selling price, allowing for the 50% sales). To achieve the $450000 turnover required, 1500 patients would need to be seen annually, or 30 patients per week.

DRAFTING A FINANCIAL PLAN(CONT.)

6. Calculate the break-even point

The break-even point is the turnover necessary to cover all costs (excluding any return on investment). It is the level below which the practice cannot afford to drop in the long term. Below this level the optometrist will be working for less than a normal salary and with no return on invested funds. Since initial sales may fall below this level, the budget should provide for at least six months of working capital.

If we assume that the variable cost is 40% or 0.4 then the remaining 0.6 is referred to as the contribution margin. This is the amount that must cover fixed costs and make a profit.

In this example the turnover is $450000. If we assume that fixed costs are $150000, then:

To calculate the break-even point, use the following formula:

BP = FC/C

Where:

BP = break-even point
FC = fixed costs
C = contribution margin.

So, in the example:

BP = FC/C= $150000/0.6= $250000

7. Produce the monthly budget

A monthly (or even fortnightly) budget is necessary to keep track of income and expenditure and to ensure the continued viability of the practice. The budget will be based on the prediction of costs in step 1 and the prediction of revenue in steps 4 and 5. The income and expenditure may vary from month to month and this should be reflected in the monthly budgets to ensure that all necessary costs are covered.

Most computer management systems will facilitate the budgeting process and also the monitoring of results against budget.

FINANCING THE PRACTICE

The information here provides the basic understanding of financial principles needed by an optometrist in private practice or managing a practice. As with the legal principles, proper professional advice should always be sought. It is also important to note that systems and expectations vary across different countries.

SOURCES OF FINANCE

There are two main sources of finance for a new optometry practice. Normally the practice will need to make use of both.

Equity funding

Equity is money the owner has invested in the business. There are two types of equity funding, money initially invested by the optometrist, including money that the optometrist has borrowed privately to start the practice, and external equity which involves new owners being invited to join the practice. Inviting a new partner or partners reduces the original partner's share and influence over the running of the practice but it does provide the funds necessary to allow for expansion of the practice. It also helps to spread the financial risk.

External funding

External funding is money borrowed from independent lending authorities, such as banks, insurance companies and creditors. Lending authorities do not acquire any equity in the practice or a say in how the practice is run, but they may have some rights to some of the assets if the practice defaults on its loans.

FINANCING THE PRACTICE(CONT.)

The types of external funding can be distinguished by the lengths of the terms of the loans, which in turn is dependent on the purpose for the loan or the life of the asset. It is generally considered that the life of the asset should not exceed the term of the finance. That is, it is unwise to be paying a loan on an asset no longer in use or deemed to have zero value.

Short-term finance

Short-term finance is generally used for working capital. That is, for such things as electricity, phone bills, stock and wages. The two main types of short-term finance are:

Bank overdraft:

A bank overdraft is a borrowing facility on the business's cheque account. The bank allows the business to write cheques up to a certain limit. It charges interest if the practice does not have the funds to cover the cheques. A bank overdraft operates in a similar way to a credit card with a pre-arranged credit limit but usually with a lower interest rate.

Creditor financing:

Frame and lens suppliers provide credit to optometrists usually at zero interest. That is, they supply the goods and require the payment at a later date. The period between supply of the goods and repayment varies from supplier to supplier but it is usually 30 days or 60 days.

Medium-term finance

Medium-term finance is used for equipment or assets with a useable life of over four years. Optometric equipment leases and car leases are an example items requiring medium-term finance.

Long-term finance

Long-term finance is normally reserved for the purchase of property and other long life assets.

OBTAINING FINANCE

Optometrists starting a new practice need to be aware of the requirements of lending authorities, and the criteria they apply when determining the suitability of a borrower.

In order to protect their investment, financiers will want to be satisfied that the optometrist has met their requirements in each of the following criteria:

1. **Appropriate use of the funds being borrowed:** The funds must be used for a legitimate business and the sustainability of the business will be an important consideration here. The lender must be convinced that the money will be used wisely.
2. **The ratio of the amount borrowed to the optometrist's own contribution to the funding of his or her practice:** The ratio of borrowed funds to owner's funds is referred to as gearing. Lenders will be wary of highly geared businesses where the amount borrowed is significantly more than the amount invested by the business owner.
3. **The ability of the borrower to repay the loan:** That is, the ability of the practice to service the loan from its budgeted income. A detailed and well argued business plan is needed by most lenders.
4. **The security offered for the loan:** That is, the collateral the lender can claim if the borrower defaults on the loan. Most lenders will not lend money without some sort of guarantee. That is, they need to be assured that, in the event that the borrower may not be able to meet the repayments, they will have some way of recovering their money. Therefore they often demand some form of security. The type of security required depends on the term of the loan and the business borrowing the money. For significant loans this may be a mortgage over the optometrist's own home.
5. **The perceived or displayed management skills of the optometrist/practice owner:** Evidence of management or supervision experience in a previous position is useful as evidence of the requisite skills.

The business plan will play a pivotal role in many of the points above. It provides the lender with details of the use of the funds (Point 1) and the ability of the business to service the loan (Point 3). It also, indirectly, provides some evidence of management skill (Point 5).

BOOKKEEPING PRINCIPLES

To some extent modern computerised management systems obviate the need to have any bookkeeping skills. Nevertheless it is useful to be familiar with the principles if not the fine detail. A reasonable understanding of accounting principles will allow the optometrist to interpret the results and the final books of account produced by the practice's accountant. Keeping good and accurate books is a requirement of good management and it will also be a legal requirement in most jurisdictions.

Bookkeeping involves a basic principle known as double entry bookkeeping, where each entry in a journal is posted to two accounts: the debit side of one account and the credit side of another account. Hence the trial balance of all accounts and final balance sheet will always be 'balanced', assuming no errors. For example, if the optometrist purchased a new asset (such as an ophthalmoscope) worth $1000, $1000 will be posted to an account called (for example) 'equipment'. This will be a debit account. $1000 will also be posted to a credit account called 'owner's equity'. If the money was borrowed then this second entry would be posted to a credit account called 'sundry creditors'. The names of the accounts are arbitrary but the practice value has increased by $1000 and the entries will show this increase in value and where the money was sourced.

The double entry system should highlight any errors that are made. With the use of computerised systems, however, most businesses such as optometry practices need only enter the data once; the computer will do the rest automatically.

It is the double entry system that allows a balance sheet to be created. All funds are represented in both sides of the sheet.

Credit side	**Debit side**
Owners equity Liabilities	Assets

The total of the assets will show the value of the business. Some of this will be owned by the optometrist/s (owner's equity) and some will still have money owning to external financiers (liabilities). The two sides must tally.

Potential investors will pay close attention to the balance sheet of any company or business. It gives some indication as to the health of the business.

THE ACCOUNTING PROCESS

The accounting process, most of which is now carried out electronically, is a logical sequence of events as follows:

1. **The transaction** These include such things as buying, selling and paying rent. For optometrists transactions include the provision of an eye test and the sale of spectacles. It also includes dealings with the practice's own suppliers, such as the purchase of frames and lenses from suppliers; the payment of rent, electricity bills and phone bills; and the payment of wages. That is, all forms of income and expenditure.
2. **Creation of source documents** These are such things as invoices and receipts. All transactions generate source documents which must be kept as a record of the transaction. The source documents for sales will be the receipt and the cash-register roll. The source documents for purchases will be the invoice. Source documents should all have the date of the transaction, the document number (receipt number, invoice number and cheque number), the company name and number where applicable, the type of transaction and the amount. The more detail on the documents the better the record is.
3. **Entry into Journals** The journals were physical books including cash journals and sales journals; however now they are sections of a computer program. Once the source documents have been checked for accuracy the data are entered into the cashbook (or computer program). The source documents should then be filed to ensure that there is a record of the transaction.
4. **Post to ledgers** There will be accounts for each creditor or each asset or each liability. With computerised systems, the journal entries will be automatically posted to ledgers. Ledgers are groups of records of like data, such as debtors' ledgers, creditors' ledgers etc. Each of the ledgers will have a number of separate accounts. So, for example, the creditors' ledger will have accounts for each of the suppliers.

THE ACCOUNTING PROCESS(CONT.)

5. **Creation of the trial balance.** Computerised systems can be set to give trial balances at any point in time. This provides an interim profit and loss statement and balance sheet for checking before the final 'books of account' are produced.
6. **Creation** of statements and reports These are the profit and loss statement, and balance sheet. They are referred to as the final books of account. They are usually produced once a year in order to complete the taxation return. The statements and reports include the profit and loss statement and the balance sheet. The profit and loss statement describes how the business has traded over the period in question, usually the previous 12 months. It produces the net profit which is the profit after all operating costs have been taken into consideration. It is the profit before tax.

The balance sheet is a description of the financial position of the practice at one point in time. It shows all assets and liabilities and so is the ownership structure of the business at that one point. The balance sheet lists the assets, liabilities and equity of the business usually at the end of the financial year (30 June in some countries or 31 December in others). The balance sheet can give some indication of the viability of the practice. It will also show how much external debt is held relative to the asset base.

The balance sheet effectively produces the accounting equation discussed earlier:

Assets = Equity + Liabilities

Just as liabilities can be divided into categories based on the length of the loan, assets can also be divided into groups depending on their characteristics as discussed below.

Fixed assets are assets that do not change over time, such as buildings, cars, and equipment, though they may be depreciated at a given rate to allow for their age.

Current assets, which are also known as variable assets, are assets that will change over the period of the balance sheet. The balance sheet will show their current value at the time of the balance sheet. These include cash at bank, debtors and stock. Investments are funds invested by the business, for example in shares or bonds.

Another group of assets, known as **intangibles**, are assets that cannot be seen or touched such as goodwill. Goodwill is essentially the worth of the patient base. A new practice will start with no value for goodwill but an established practice will have a patient base that will be valued by potential investors in the practice. The goodwill will normally be a function of the turnover or patient base and its value will be mirrored in an increase in the owner's equity.

PROCESSING DOCUMENTS

Processing documents are the sources for the entries into the computer system. For example, lenses and frames and any other goods purchased for the practice will be supplied with a delivery docket and invoice. It is important that these documents be checked for accuracy and that the goods are examined for good condition and matching the invoice. All invoices should be stored chronologically so that they can be easily retrieved.

There can be an advantage in outsourcing the processing of documents and accounts to a professional accountant or book keeper. This enables the owner to concentrate on running the business.

Obtaining regular profit and loss statements provides information about the business performance, updates on cash flow requirements, inventory purchasing and staffing costs.

RECONCILIATION OF CASH

Daily cash checks

At the end of each day it is important to reconcile the money and other forms of payment in the cash register with the totals of the cash register rolls. An error would suggest either a processing error or theft.

Bank reconciliations should also be carried out each time a bank statement is received. It is important that they be checked with the practice's own records by comparing cheque butts with the cheques listed on the bank statement and by comparing the practice's cashbook with the statement.

PROCESSING DOCUMENTS(CONT.)

Periodically debits will appear on the bank statement which the practice would have been unaware of, such as bank charges and taxes. These must now be included in the cashbook to account for the fact that a payment has now been made.

The reason that the bank refers to money owing by the practice as a debit while the practice records it as a credit is the different point of view of the two parties. While the bank will be considered as a creditor by the practice, the bank will consider the practice as a debtor.

SUMMARY

Chapter 7 covered the main principles of financial management of an optometry practice, including some basic accounting skills. While most bookkeeping in small businesses is now done by computers, an ability to interpret the results is still necessary. The concept of gearing is particularly important when analysing balance sheets.

Optometrists will need to understand the significance of various aspects of the annual financial statements. All business owners must take a close interest in the financial management of their business to reduce the chances of error or fraud.

SELF ASSESSMENT 7

1. **What is the accounting equation?**

2. **What is the break-even point?**

3. **What are the two main sources of funding and what are the main features of each?**
   a. _____
   b. _____

4. **What is the main principle guiding the length of a loan?**

5. **What is meant by gearing?**

ANSWERS – SELF ASSESSMENT 7

1. **What is the accounting equation?**
   Equity = Assets – Liabilities or Assets = Equity + Liabilities

2. **What is the break-even point?**
   The break-even point is the turnover necessary to cover all costs (excluding any return on investment). It is the level below which the practice cannot afford to drop in the long term.

3. **What are the two main sources of funding and what are the main features of each?**
   a. **Equity funding** is money the owner has invested in the business. There are two types of equity funding, money initially invested by the optometrist, including money that the optometrist has borrowed privately to start the practice, and external equity which involves new owners being invited to join the practice.
   b. **External funding** is money borrowed from independent lending authorities, such as banks, insurance companies and creditors.

4. **What is the main principle guiding the length of a loan?**
   The length of the loan should not extend beyond the life of the asset.

5. **What is meant by gearing?**
   Gearing is the ratio of borrowed funds to owner's equity.