Know Your *Numbers*

Keeping track of your inventory and expenses is the path to pharmacy profitability

by Scott W. Sykes, CPA, CGMA

Do you view accounting as not important or a burden? If you were to pull up a balance sheet of your pharmacy, how confident would you be in those numbers? On a scale of one to 10, how important is inventory on your balance sheet? Are you reporting third-party accounts receivables on your tax returns and financial statements? If you answered "no" or "I don't know" to any of these questions, you're not alone.

If you aren't sure how your pharmacy accounting stands in comparison to your peers, then look no further. The following accounting mistakes highlight common areas that should not be an issue for a pharmacy owner. Unfortunately, these mistakes often cost tens of thousands of dollars or cause owners to miss opportunities in the pharmacy and leverage proactive tax strategies.

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ACCOUNTING IS NOT IMPORTANT

The most successful pharmacies understand this one bold fact: accounting is the foundation of their business. So why are you not doing everything you can to leverage that accounting foundation to help grow and serve your patients? Now is the time. Weak reimbursements and tight margins are just another reason why you must have a reliable accounting system.

If you are wondering if you have a reliable accounting system right now, then you most likely do not. You know when you have a reliable system in place. It streamlines all day-to-day processes using technologies and daily bank reconciliations, and ties in your daily deposits to the point-of-sale reports. Streamlining the payable processes electronically frees you up from hand signing checks—this is 2017, not 1985. Detailed weekly status reports customized to what you want to see is how you "check your bank account." A reliable accounting system and efficient daily processes give you a foundation of integrity, so when it is time to review your monthly financial statements or tax plans you know that what you are looking at is accurate, timely, and valuable.

NO INTEGRITY IN THE BALANCE SHEET

This and all of the other mistakes listed in this article tie into the false idea that accounting is not important. Accounting *is* important and is fundamental to your pharmacy, so having that reliable accounting system in place is crucial. So crucial, in fact, that if you do not have a reliable system in place, there is a strong chance you are making this accounting mistake.

The balance sheet is a snapshot in time of your assets, liabilities, and equity. It changes every day as your bank account updates, your inventory changes, and your receivables fluctuate among all the other accounts. Your balance sheet on paper should change too as your accounting system operates day in and day out. Each account on that balance sheet should also be reconciled to the penny each and every month. The accounts payable at the end of the month should be exactly what you owe vendors. The credit cards and bank accounts should also be reconciled at month's end. When you implement efficient and reliable daily accounting processes, most of this work is already done for you. There are, of course, accounting adjustments to be made for depreciation, inventory, and third-party receivables that someone should assist you with who has knowledge of the industry. This leads me to the next mistake.

NOT UNDERSTANDING HOW INVENTORY IMPACTS GROSS MARGIN

One key component of your pharmacy balance sheet is inventory. This area is often confusing for pharmacy owners and their accounting staff. The inventory shown on your balance sheet directly impacts your bottom line on the profit and loss statement, so it is vital you understand how this impacts your pharmacy and pay close attention to this figure daily, weekly, and monthly.

When a bottle of 1,000 pills is purchased, there are two accounting entries: an increase in payables for the cost of the drug, and an increase in inventory. When a prescription is filled for 30 pills, inventory is obviously less at 970. That decrease in inventory or the cost of those 30 pills is now shown as cost of goods. As a result, you have revenue from the 30 pills minus the cost of those 30 pills which equals your gross margin. As we all know, your margins are extremely important to your pharmacy, so this piece of the balance sheet puzzle is vital.

So, how do you know what your cost of goods is when filling hundreds or thousands of scripts? Well, you know what you purchased as listed in your accounts payables and, if you have a reliable perpetual inventory system or an actual physical count, you know your inventory levels at month's end. This adjustment to inventory will give you the most accurate cost of goods, gross margin, and, ultimately, net income.

AN INCORRECT ACCOUNTING METHOD

Generally, most pharmacies are *required* to report on the accrual basis of accounting, not the cash method. The accrual basis of accounting means that revenues and expenses are recorded when incurred, not when collected or paid. The cash method records revenues when money is received and when checks are cleared. Are you reporting on the correct method of accounting?

Two common mistakes we see are not reporting on the accrual basis when required and incorrectly reporting accrual. For those who are not sure what method to use, it is listed on your pharmacy tax return. From there, if you are on the cash basis and should be accrual, you will need to change your method of accounting. This change is fairly standard and requires a few additional forms with your pharmacy tax return. Your accounting professional should be able to handle that, but if they missed the correct reporting basis on your tax return, you may want to seek another tax advisor. Reporting on the cash basis does not provide valuable accounting data for a pharmacy as so much of a pharmacy's business is on the accrual basis, such as income from third-party receivables.

For those who are on the accrual basis and required to report on the accrual basis as indicated on your tax return, review the tax return balance sheet to be sure. Are you reporting third-party accounts receivables? You certainly should be. Are you reporting your payables, your liabilities such as accrued wages, sales tax payable, and payroll? Hopefully you are but, again, if you are required to report on the full accrual as most pharmacies are, you should be doing just that reporting on full accrual. If you find you haven't been reporting third-party receivables—a common mistake for those certified public accountants who do not understand pharmacy accounting—or any other mistake, you can file a Form 3115 with the IRS to fix the error. Filing the Form 3115 usually gives you audit protection for that error and allows you to potentially spread out any additional tax from the error over a four-year period.

RELIABILITY AND EFFICIENCY ESSENTIAL

As you can see, accounting for a pharmacy is complex and ever-changing. However, having a reliable and efficient accounting system in place can help you adapt and stay ahead. Not only do you catch issues with a reliable accounting system, you are also able to be proactive with tax strategies. There shouldn't be any delay in knowing where you stand day in and day out. Ultimately, you'll be in a better position and will have more time to manage, lead, and grow your pharmacy, all while taking better care of your patients. ■

Scott W. Sykes, CPA, CGMA is with Sykes & Company, P.A., working directly with pharmacy owners, assisting with day to day accounting and tax compliance issues. He is also active in year-end payroll preparation, tax planning, individual tax preparation and corporate tax preparation for pharmacy owners and businesses.