By Craig T. Williams

How to Develop an Effective Budget for Your Practice

Now's the best time to start planning how your practice will operate next year. In part one of a two-part series, we'll look at how to collect the data you need to budget for 2007.

One key characteristic that all successful medical practices have in common is their ability to create, manage and adhere to a realistic budget. Many groups never manage to establish a budget, and still others go through a great deal of work to formulate a budget but then never use that information again. This is unfortunate, because without a realistic and measurable accounting of income and expenditures practices run an increased risk of a wide array of problems including embezzlement, over- or understaffing, physician compensation issues, cash flow shortages and limited resources available for practice improvements and growth. With a strong budget, though, the strengths can be augmented and the weaknesses can be reduced.

In my experience as an administrator, I've found that just going through the process of creating and maintaining a budget creates the required business discipline to chart a course through good and bad times. So whatever the forecast is for your practice, it's important to take stock of its cash flow.

A Big Picture of Little Costs

The foundation of creating a good budget is to have an established process to track practice expense and revenue. It is critical that all medical practices establish a chart of accounts to properly track both of these categories with the most accurate and updated information available.

For the purposes of this article, I will assume that practices already have an established and utilized chart of accounts and are producing monthly and year-to-date financial statements.

Realistically, a medical practice should begin the budget process for the coming year about five months before the beginning of the next fiscal year. The first step in this process is to analyze the current year's financial performance and to develop a projection of where you believe it will finish financially. For instance, if you begin to develop your budget in the seventh month of the current fiscal year, you would want to project a full 12-month financial performance based on the seven months of information that you currently have.

One easy way to project the current year would be to do a "straight-line" annualization of the current year's financial performance. In other words, if you had $700 of expenses through seven months, you would project $1,200 of total expenses for the year. Usually the straight-line method needs to be adjusted for issues like practice seasonality, any known adjustments that need to be made for upcoming expenditures or one-time expenditures that have already occurred, or new physicians joining the group. To make the seasonality estimates, analyze the prior years financial and productivity performance through the first seven months versus year-end.

Once you have developed a realistic year-end forecast, you should begin to think about factors that existed this year that may be different in the coming year:

• Will the current staffing levels be maintained?

• Are there any new providers joining or current providers leaving the group?

• Are there any changes expected in leasing arrangements or the cost of utilities?

• Will you offer the practice's employees an increase in compensation?

• Have you negotiated any new managed care contracts or do you have current contracts that will provide for an increase in collections?

• What is the projected change in reimbursement for neurologists from the Medicare and Medicaid Programs?

• Do you have any strategies to change or improve your payer mix?

• What is the competitive environment and how might it change your reimbursement levels or productivity?

• Do you have targeted productivity goals for your providers and how does that effect overall compensation?

These are just a few examples of issues that may require changes in budget assumptions from year to year. I find it helpful to have a meeting with the key physician leaders of my practice to brainstorm for ideas. There are often things that practitioners are aware of that do not hit the radar screen of a practice administrator that may have a huge effect on the budget process and vice-versa.

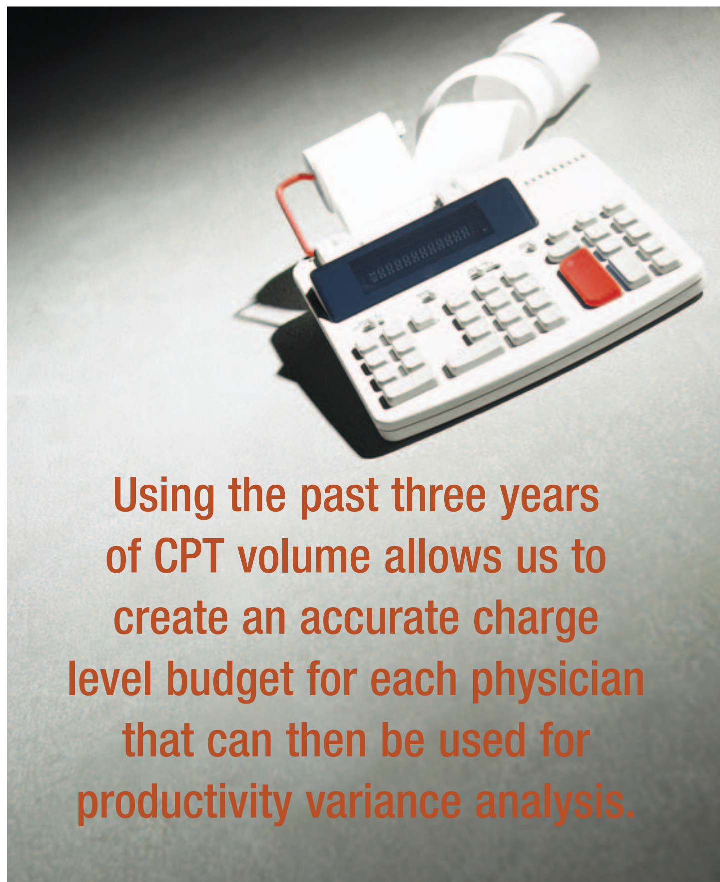
This outlines a general approach to creating a budget. With this in mind, let's dive into the specific components of the budgeting process.

Revenue Budgeting

This phase should begin with an accurate estimate of gross patient service revenue or total charges. We have found that a good way to develop this forecast is to get the details of the past three years of volume by CPT code distribution at the

physician level. By building the revenue budget up from these data, we can make assumptions about changes in coding, physician activity or service offerings.

Using the past three years of CPT volume allows us to create an accurate charge level budget for each physician that can then be used for productivity variance analysis. If we have a new physician joining the group, we try to model the expected revenue based on a similar provider in that subspecialty with a ramp up period based on past experience. Once we have developed the physician level revenue budget, we sum up the expected activity for the department.



The next step in creating a revenue budget is to estimate the percent of collections and bad debt (expense category) that we would expect based on historical collection experience, new or current contractual rate increases, changes in Medicare and Medicaid reimbursement. We build this collection percentage estimate by looking at current payer mix as a percentage and then applying expected reimbursement changes and payer mix changes to arrive at an expected overall collection rate. This rate is then applied to the expected charges to create the practice revenue budget.

Expense Budgeting

In my experience, the trickiest part of this component is forecasting employee salary and wage and full-time equivalent (FTE) figures. We do this by taking a current payroll run of all employees and then look at all the advertised vacancies to build out expected FTEs for the coming year. We then analyze when each of those employees or new hires will be eligible for a yearly merit increase and inflate their salaries based on that information. After this, we adjust the total expected salaries by a historical vacancy rate (*i.e.*, the rate at which jobs become vacant and are then subsequently refilled), which usually results in a decrease in salary expense.

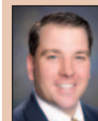
Physician salary and wage budgeting will vary based on the compensation plan that exists in your practice. In many cases, the calculation of physician compensation will vary greatly depending on individual physician's productivity. This requires a marriage between the individual physician's revenue budget build-up and the calculation of compensation expenses.

For other expenses related to running a practice, we attempt to categorize them into broad groups and then apply expected inflation factors. For example, we may know that our rental expense per our lease agreement will see an inflation of six percent per year; however, office supplies would see a more generic inflation assumption of 2.5 percent increase per year. For many of our inflation assumptions, we make use of whatever readily available price level predictions we can find.

New Programs

In most cases, we try to create a "baseline" budget that reflects the steady-state of the practice without our plans for new programs or new physicians. We then identify any new programs that may occur and develop a budget specifically for each one. Depending on the size of a practice, this could be as simple as a new physician joining the group or as complex as opening a new site with multiple providers and employees. The reason we carve these out is so that, when the program actually gets up and running, we can measure the actual performance against the expected performance.

Using the budgeting techniques outlined above will provide you with a roadmap to developing a budget for your practice. In next month's issue, I will discuss how you use that budget in the coming year to develop a variance analysis approach to practice management. **PN**



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