CONTINUING EDUCATION

Pharmacy accounting and cash flow fundamentals

by Scotty Sykes, CPA, CFP

Dec. 1, 2021 (expires Dec. 1, 2024)
Activity Type: Knowledge-based
To earn continuing education credit:
ACPE UAN: 0207-0000-21-305-H04-P;
ACPE UAN: 0207-0000-21-305-H04-T

By the end of this program, pharmacists will be able to:

1. Identify the essential components of a back-office accounting system.
2. List notable accounts on the balance sheet.
3. Discuss key performance indicators in an independent community pharmacy.

By the end of this program, technicians will be able to:

1. Identify the essential components of a back-office accounting system.
2. List notable accounts on the balance sheet.
3. Discuss key performance indicators in an independent community pharmacy.

NCPA® is accredited by the Accreditation Council for Pharmacy Education as a provider of continuing pharmacy education. NCPA has assigned 1.0 contact hours (0.1 CEU) of continuing education credit to this article. Eligibility to receive continuing education credit for this article expires three years from the month published.

FREE ONLINE CE. To take advantage of free continuing pharmacy education (CPE) for this program, pharmacists and pharmacy technicians must achieve a passing score of 70% on the online continuing education quiz for the program. If a passing score is not achieved, one free reexamination is permitted. To take this test, go to **ncpa.org/learn**. You will receive immediate online test results and credits will be posted to CPE Monitor within six weeks.

The COVID-19 pandemic accelerated much change in the pharmacy industry. Pharmacies were quickly identified as essential businesses, and as a result, many were required to stay open and serve their communities, which they did with flying colors. Suddenly, government relief funding was flooding into pharmacies. In the blink of an eye, pharmacies were working to keep employees safe while caring for their patients, changing their workflow, adapting new cash-based revenue streams with COVID testing, and sitting on extra cash brought about by the CARES Act through the Paycheck Protection Program, the Health and Human Services Provider Relief Fund, or perhaps Economic Injury Disaster Loans.

It wasn't by chance that some pharmacies were able to quickly adjust and will ultimately come out of the pandemic stronger than ever compared to their peers. Several variables and factors are reasons for these pharmacies outperforming the norm, but one factor is common among many successful pharmacy owners that continue to weather the pandemic: the accounting back-office.

The back-office accounting functions are the foundation of any business, especially pharmacy. With tight gross margins, DIR fees and payroll costs, the bottom line (and cash flow) can be razor-thin if a pharmacy is not performing optimally. Therefore, it is critical that pharmacies have a sound financial foundation and an accounting system that gives pharmacy owners a solid grip on how their pharmacy is performing at any given moment. Pharmacies that have this foundation can quickly adjust and better manage their business and resources.

What is a sound financial foundation and accounting system in a pharmacy? A sound financial foundation includes defined accounting processes using technology to ensure prompt information is compiled into the financial system with integrity. Let's take a deeper dive into what components are included in a sound financial and accounting system.

Table 1: Key performance indicators

Gross margin
Third-party accounts receivables
Inventory
DIR fees
Payroll expenses
Current ratio

REVENUE

What happens behind the counter with point-of-sale transactions is a key starting point in this process. The POS system captures what happens day by day. This system should be pushing out summary reports that display sales/revenue, returns, sales tax, and payments by cash, checks, credit card, and other information. This data is foundational and should be reconciled into the accounting system often to ensure that what happens behind the counter is getting into the bank and reconciles with the accounting system. This is real-time data getting into the system with integrity, with checks and balances or internal control over the cash and checks.

This step, however, is often overlooked or not performed at all. This adds risk to the theft or misappropriation of cash and/or checks. It also omits details in the accounting system from what is happening at the counter, such as cash short or over balances. Many pharmacies will just reconcile the bank at the end of the month, or even worse at the end of the year (or never)! If you do not have a process in place to ensure integrity behind the counter with the point of sale and if you do not incorporate this information into the accounting system, you have a significant void in your accounting system.

One key component of revenue, outside of the daily processes with the point of sale, is third-party accounts receivable. Pharmacies have a large amount of receivables/revenue from various third parties, therefore this account is especially important to determine accurate revenue and thus, gross margin. Some pharmacy owners do not actually know what they are owed at any given time from third parties, and that data is often missing in the accounting system. In these instances, third party receivables are your largest unreconciled bank account.

What are the best practices for third-party receivables tracking? Manual third-party reconciliation is time consuming, inefficient, and costly, and is not advised in today's marketplace. Technology is available to provide reconciliation services for a reasonable fee in real time. This technology can chase claims that are short along with catching errors in payer trends and reimbursements. It will also provide additional data you can use to understand your pharmacy, and it allows you to capture DIR fees which are your third largest expense in the pharmacy. More on that later.

It's important to note that technology does not replace management of these reconciliation systems. Two best practices are to train a designated staff member in managing and updating the system periodically, and then schedule times to work with your service provider adviser to ensure integrity in the system.

COST OF GOODS SOLD

Another key aspect of a sound financial or accounting system is the cost-of-goods-sold account. The accounts payable function for your expenses is a key component to this. All pharmacies have payables, and it's important that these payables get into the accounting system as occur. With this system in place, the pharmacy owner can pull a report to see exactly who they owe and the aging of those payables. Additionally, these payables are accounted for in the accounting system in real time, giving you data with integrity when a profit-and-loss statement is produced. If expenses are not recorded until they clear the bank, the timing of your accounting system is off, and as you examine your pharmacy performance, that can lead to skewed data and analysis. Technology can handle much of the accounts payable function with reduced time, effort, and cost compared to any manual process.

One particularly important expense that should be exact is the amount owed or payable to the wholesaler, including secondary wholesalers. These expenses affect your cost-of-goods-sold account directly. This account is vital in determining the number one key performance indicator in a pharmacy, the gross margin. Revenue minus cost of goods sold will equal your gross margin. Gross margin for the average retail pharmacy falls around 22 percent. As we will continue to learn, this figure and percentage is critical, so it is important that great care is taken to ensure accurate revenue and cost of goods sold.

Table 2: Gross margin formula

Revenue – Cost of Goods Sold = Gross Margin

Along with accounts payable, inventory is also a key factor when determining the cost of goods sold, which will help us determine our gross margin, again the number one key performance indicator. To dive deeper into cost of goods sold, let's start with the cost-of-goods-sold formula.

Table 3: Cost of goods sold formula

Beginning Inventory + Purchases – Ending Inventory = Cost of Goods Sold

As you can see, this formula starts with beginning inventory, adds purchases for the period, subtracts ending inventory to equal cost of goods sold. First, if beginning inventory lacks integrity, eventually the adjustment will average out as the ending inventory is adjusted accurately each period. Any significant and material differences with beginning inventory should be addressed separately as in an amended tax return or other means your advisers deem appropriate.

Second, as previously mentioned, purchases or accounts payable is a key component here. You must ensure your accounting system has a process in place to capture on the books all payables to your primary and secondary wholesalers. Third, an accurate ending inventory at cost will eventually equal an accurate cost of goods sold. Care should be taken here with each element of the formula.

Guessing on a month-end inventory figure or not including all your wholesaler payables into the accounting system could prove detrimental to your pharmacy account-

Table 4

Example 1
Facts:
ABC Pharmacy Inc. has revenue of $350,000 for the month. **Beginning inventory** at the pharmacy is $200,000. The pharmacy **purchases** $250,000 of inventory for the month. At month-end, the PIC *guesses* that **ending inventory** is the same as beginning inventory - $200,000.
Accounting:
Beginning inventory $200,000 plus purchases $250,000 minus ending inventory $200,000 equals cost of goods sold $250,000. Revenue of $350,000 minus cost of goods sold $250,000 equals gross margin of $100,000. Gross profit margin is 28.5 percent.

Example 2
Facts:
ABC Pharmacy Inc. has revenue of $350,000 for the month. **Beginning inventory** at the pharmacy is $200,000. The pharmacy **purchases** $250,000 of inventory for the month. At month-end, the PIC performs an *actual count* and determines that **ending inventory** is slightly lower than beginning inventory - $180,000.
Accounting:
Beginning inventory $200,000 plus purchases $250,000 minus ending inventory $180,000 equals cost of goods sold $270,000. Revenue of $350,000 minus cost of goods sold $270,000 equals gross margin of $80,000. Gross profit margin is 22.9 percent.

ing. Inaccuracies may cause your accounting system to understate or overstate your margin and ultimately your bottom line (and potential tax liability!). It is difficult to understand your pharmacy metrics as compared to those of your peers, maximize cash flow, plan for tax mitigation, or take advantage of new opportunities if this fundamental component lacks integrity.

What do we learn from the examples in **Table 4**? Guessing, versus knowing your actual ending inventory, changed the entire dynamic of how this pharmacy is performing. If this was year-end, the tax liability would have been higher by the difference in income of $20,000. Relying on inaccurate data to determine your pharmacy performance and margin could have affected other important decisions within the pharmacy such as cash flow, new hires, diversified service lines, to name several.

Beyond determining your number one key performance indicator, inventory management is an essential portion of a successful pharmacy. As you know, the bottles on your shelf are $100 bills; when the inventory is not managed well, that likely means more cash than you want is sitting on the shelf than in the bank. Maximizing your inventory turns and keeping a lean stock that you can actively manage and optimize with technology based on supply and demand may help you keep that cash in the bank and not on the shelf.

Inventory turns ideally should be higher than 20 on an annualized basis. With the norm in the industry around 11, much opportunity is available here for pharmacies. High turns mean pharmacies are keeping a lean, efficient inventory stock and keeping cash in the bank. With next-day delivery, medication synchronization and technology to maximize your filling trends, there is little reason you should be around just 11 turns on an annualized basis.

Table 5: Inventory turnover

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Value of Inventory}}$$

An important tool to ascertain ending cost of goods for the period and maximizing the potential for inventory turns is a perpetual inventory system. It is nearly impossible to maximize net profit and cash flow without a pulse on inventory through a perpetual system. Many prescription systems have perpetual inventory system capability and allow you to schedule periodic counts to ensure accurate quantity on hand. Technology is also available to help you craft reorder points according to supply-and-demand trends. It is important that you have accurate cost downloads taking place in your system and that any secondary wholesaler acquisition costs are not overridden in the system. This will ensure data on inventory costing is as accurate as possible, especially if the perpetual inventory balance at the end of a given period is being incorporated into your accounting system as it should.

Physical inventory counts are also a necessary tool inside your pharmacy. Annual physical counts in the third or early fourth quarter will true-up your perpetual system and give you a solid data point for gross margin and your bottom line, which then can complement or reinforce your pharmacy performance metrics and give you confidence in the accounting figures for proactive tax planning strategies and mitigation.

PAYROLL EXPENSE

Outside of cost of goods sold, payroll is the second biggest expense in a pharmacy, and therefore can make or break your bottom line. Payroll is administratively burdensome, time consuming, complex, and stressful. Reporting to multiple agencies on a periodic basis with the constant stress of keeping up with changes to the law often leads to errors and agency notices. Therefore, organized recordkeeping and timely payment of payroll taxes is a must. On the other hand, outsourcing this burdensome process using technology will help produce real-time data in the accounting system and will help remove most of the stress associated with payroll.

Common payroll benchmarks for average retail pharmacies are measured by a percentage of revenue. Total gross payroll, not including benefits, should be approximately 10.5 percent of total gross revenue and the associated payroll tax should be approximately 0.9 percent. Of the total gross payroll percentage, owners should fall around 3 percent of total gross revenue. Gross payroll above 11 percent is certainly a red flag for a retail pharmacy not involved in LTC, compounding or any other special services. With tight margins, excess payroll can shatter your bottom line and cash flow. High performing pharmacies will have total gross payroll in the single digits of total gross revenue, suggesting that they run highly efficient processes and streamlined workflow within their pharmacies. What remains to be seen at the time of writing, however, is the affect the current pandemic labor market has on payroll percentages in 2021 and beyond.

There are numerous best practices for exceeding payroll benchmarks. Automation such as robots or pill counters are great tools to streamline your workflow and cut out manual processes. Knowing your revenue per hour on a weekend is typically a quick way to determine optimal hours of operation for those days that are not worthwhile to remain open. Perhaps you could close the front end of the store for a few hours in the morning and only open the drive thru. This may cut excess staff wages that you may not need to incur. Focusing on training and retaining staff is key, as turnover can be costly. Overtime can also crush benchmarks for payroll, and high overtime may even suggest poor workflow and inefficiencies. Overall, being creative with payroll, workflow, processes, and hours of operation will certainly help you find a fit that exceeds benchmarks and feeds your bottom line.

DIR FEES

Direct and indirect renumeration fees are now the third biggest expense in a pharmacy. DIR fees have trended higher each year since transparency made this data more widely available. Today's marketplace allows third-party reconciliation systems to pull the DIR data, and other adjudication costs, from the 835 files that are remitted with third-party payments to the pharmacy. These fees have trended higher each year and are now categorized as the third largest expense to a pharmacy behind cost of goods sold and payroll. The 2020 average was 2.5 percent of gross revenue. A pharmacy with $4 million in revenue with average DIR fees in 2020 would equal $100,000. That is an amount that pharmacies should do everything they can to mitigate.

Despite lack of control to a large degree, reducing DIR fees is possible. Again, with this being your third largest expense, managing this is important to your bottom line and cash flow. There is a clear correlation between EQuIPP Star Ratings at "5" or 99 percent and the lowest DIR fees. Even pharmacies with EQuIPP Star Ratings at "4" and/or 90 percent have significantly higher DIR fees than those with an EQuIPP Star Ratings score at 5. Often, there is a correlation between lower DIR fees and increased generic dispensing. Maximizing MTM opportunities and improving patient adherence with alternatives like packaging also have a positive correlation to lower fees. Overall, understand your contracts, patients, and DIR fee structure with your payers, and find ways to meet or exceed all benchmarks. Of course, when you venture into other cash based or non-PBM revenue sources, that is sure to minimize these fees overall as well.

BALANCE SHEET

Let's put together everything we have learned so far and go over the balance sheet. The balance sheet is a snapshot in time and is an especially vital component of the financial reports because it affects profit and loss in various ways. Any inaccuracies on a balance sheet may lead you to a wrong conclusion on your pharmacy performance, bottom line, and cash flow.

The balance sheet will display your assets, liabilities, and equity at a given point in time. Assets always equal liabilities plus equity. This is an important formula that will help you better understand and read a balance sheet. Assets such as inventory and third-party receivables and liabilities such as accounts payable are important accounts that impact the integrity of the profit and loss, which is why we spent much time on these previously.

Table 6: Accounting equation

Total Assets = Total Liabilities + Total Equity

Table 7: Notable accounts on a balance sheet

Assets	Cash Receivables Inventory Fixed Assets
Liabilities	Accounts Payable Notes Payable Payroll Payable Sales Tax Payable Credit Card Payable
Equity	Retained Earnings Capital Stock Additional Paid in Capital Owner Distributions (Terms may vary depending on tax status)

A key performance indicator on a pharmacy balance sheet is the current ratio. This ratio simply tells you how much cash, receivables, and inventory (current assets) you have for every dollar of debt, or in other words, how strong your cash flow or liquidity is in the pharmacy. Current assets divided by current liabilities will equal your current ratio. Take great care to ensure your current assets and current liabilities are correctly classified so you can get an accurate current ratio. An average ratio would be 2.5 to 1. Anything below 2 to 1 is a red flag, and anything above 3 to 1 is good. This ratio simply tells you how much cash, receivables, and inventory (current assets) you have for every dollar of debt, or in other words, how strong your cash flow or liquidity is in the pharmacy.

PROFIT AND LOSS

With a grip on the balance sheet, let's talk about the profit and loss. As mentioned, profit and loss is only as accurate as your balance sheet, which is why we always start our analysis at the balance sheet. The profit and loss will ob-

viously display your bottom-line profit or loss. The bottom line in a retail pharmacy should be in the 3-7 percent range as a percent of gross revenue. As we have discussed, gross profit, payroll expenses, and DIR fees are the three key drivers of your bottom line. Most other overhead costs are important to the bottom line in a pharmacy, but in many cases do not move the needle on profitability.

A correct profit and loss statement is critical as you analyze your key performance indicators and pharmacy performance, but it is also important for proactive tax planning. Proactive tax planning is designed to mitigate your tax and maximize your cash flow with various strategies that meet your goals and objectives, but also keep more cash in your bank. Accurate numbers are vital to proactively weigh your opportunities and strategies. Waiting until after the end of a year to plan for taxes will only allow you a small arsenal of options to mitigate tax and minimize the hit to your cash flow. A solid accounting system which produces accurate financial reports can help you plan before year-end and implement strategies, so you have control over April 15.

ACCOUNTING METHODS

When reporting business income to the Internal Revenue Service on your tax return, you must now decide which accounting method to use. An accounting method is the system a taxpayer uses to regularly compute income in keeping the books. The accounting method determines the timing of when items of income and deduction are recognized. The two overall accounting methods applicable to pharmacies are the accrual and cash methods of accounting.

The accrual method recognizes revenue when earned such as when a prescription is adjudicated, and it recognizes expenses when incurred, such as when a purchase is made instead of when it is paid for. This method would include, among other things, reporting as income third-party insurance receivables due to the pharmacy and would include as payables, monies owed to the wholesaler and other vendors for expenses incurred. On the other hand, the cash method of accounting recognizes revenues when the revenue is received constructively and recognizes expenses when the expenses are paid. Third-party insurance monies owed to the pharmacy are not recognized and reported as income under the cash method of accounting until received. As you can see, the key distinction between the two methods is simply the timing of when income and expenses are recognized.

Pharmacies prior to the Tax Cuts & Jobs Act of 2017 were required to report on the full accrual method of accounting unless exceptions were met. The TCJA has changed the accounting method options available for pharmacies for tax years after Dec. 31, 2017. Unless your prior three-year average gross revenues (gross receipts test) in the pharmacy exceed $26 million dollars, pharmacies are now allowed (not required) to report on the cash method of accounting instead of the accrual method for tax purposes. Please note, owners with multiple pharmacies under common ownership (such as controlled groups) must aggregate gross receipts when determining the gross receipts test. These rules can get complicated, so speak with your advisers to ensure you remain in compliance.

Pharmacies need to keep their books and records in conformity with tax reporting. Best practices support pharmacies tracking their financial information on an accrual basis, not a cash basis to accurately reflect reality in the pharmacy. As we have learned in this article, accrual basis items are generally material items in a pharmacy and should be considered when determining key balance sheet and profit and loss ratios and analysis. Be very careful switching to the cash method and not adjusting back to an accrual method on the books. As we have learned, accrual accounts such as accounts receivable and accounts payable have a significant impact on your financial reports, which are vital to helping you understand your pharmacy performance.

CONCLUSION

The accounting system is foundational to all businesses, but especially pharmacy. The inherent cash flow issue, tight margins, DIR fees, and so on leave little room for error in a pharmacy. Likewise, pharmacies must have a grip on the accounting fundamentals, on a full accrual basis, so a pharmacy owner can have a pulse on their business and understand the cause and effect of any issues they may be experiencing inside the pharmacy. It is important to make all adjustments each period so the pharmacy owner can be confident in the figures and percentages and make the correct decisions regarding cash flow, expenses, or debt management. Furthermore, tax planning is such a key part of cash flow management that a pharmacy must have a foundational accounting system to proactively plan and weigh strategies for mitigating taxes. Without these fundamentals, pharmacies are operating in the dark and likely missing key opportunities to evolve into the health care centers of their communities. ■

Scotty Sykes, CPA, CFP, is with Sykes & Co., P.A., Edenton, N.C.

For information on source material used in this article, please contact Chris Linville, America's Pharmacist® managing editor, at chris.linville@ncpa.org.

CE QUIZ

Continuing Education Quiz

Select the correct answer.

1. Why is accounting important for pharmacy?
a. Better understand cash flow
b. Assist with tax mitigation
c. Enhance management, growth, and profitability
d. All of the above

2. What is an example of a daily fundamental process?
a. Daily bank reconciliations and point-of-sale accounting
b. Tax planning
c. Month-end adjustments
d. Advertising expense

3. Liabilities + equity =
a. Profit
b. Cash flow
c. Current ratio
d. Assets

4. What is a key asset on the balance sheet?
a. Cash
b. Accounts receivable
c. Inventory
d. All of the above

5. What account is often left unreconciled?
a. Fixed assets
b. Accounts payable
c. Other income
d. Third-party receivables

6. Poor management of what can have a detrimental effect on cash flow for a pharmacy?
a. Inventory
b. Other assets
c. Depreciation
d. None of the above

7. Which of the following is a balance sheet key performance indicator for cash flow?
a. Net income
b. Current ratio
c. Overhead percentage
d. Payroll percentage

8. Pharmacies should report for internal purposes on the ____ basis method of accounting?
a. Accrual
b. Cash
c. Direct deposit
d. None of the above

9. What is the third largest expense in a pharmacy?
a. Payroll
b. Utilities
c. DIR fees
e. Meals

10. What accounts are included in the cost-of-goods sold calculation?
a. Cash
b. Inventory
c. Receivables
d. Accounts Payable/Purchases
e. a. and c.
f. b. and d.