Continuing Education

# BUSINESSSOLUTIONSCE

## Understanding a Pharmacy's Financial Statements and How to Analyze Them

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## Learning Objectives:

Upon successful completion of this lesson, the pharmacist will be able to:

1. Understand the financial statements for a pharmacy and how to read them
2. Understand the basic terms used in financial statements
3. Differentiate between a balance sheet and an income statement
4. Calculate financial ratios
5. Use ratios and calculations to analyze a pharmacy's financial statements
6. Understand how he or she can have an impact on financial ratios

Every year, your patients have an annual medication review. You use this opportunity to review whether changes need to be made to their current medications. You review if doses and medications need to be increased, decreased, or eliminated. You review whether supplements need to be added or removed. You determine if referrals need to be made and further testing done.

Every year your accountant draws up your financial statements. What do you do with these? Do you use them to review whether you need to change your current business model? Do you review whether profit needs to be increased or expenses decreased? Do you review whether assets need to be added or liabilities removed?

If you are like most pharmacy owners, you probably do a great job with medication reviews. However when it comes to financial reviews, you probably don't have the time. You spend most of your time improving your patients' health but very little time helping your pharmacy's financial health.

In this continuing education lesson, we will review why it is important to review your pharmacy's financial health. We will also explain financial statements and common ratios and calculations that you can use to review your pharmacy's financial health.

### Why is it Important to Review your Pharmacy's Financial Statements?

Before you fill a prescription, you review your patient's profile to see if there are any changes in medication. Similarly, you need to review your pharmacy's financial statements to understand the changes in its financial health.

There are two main financial statements that pharmacies use: the balance sheet and the income statement (also known as the profit and loss statement). At a minimum, you should review your financial statements annually. You should be comparing your pharmacy's performance to previous years (to see trends) and to industry standards (to see how you compare in the marketplace). Ideally, your annual review should take place with your accountant or financial advisor who is familiar with industry standards.

If you have a new pharmacy business (less than three years old) you should be reviewing your financial statements quarterly. This will ensure that you can take any corrective action required if your pharmacy is not growing according to your initial projections.

If you are an established pharmacy (greater than three years old) and there are regulatory changes that will affect your pharmacy, you should be reviewing your financial statements just before the regulatory changes take place and then four months later to determine the impact on your pharmacy and to take any corrective action.

### Why is it Important to Understand your Financial Statements?

You are filling two prescriptions for pantoprazole and clopidrogel for a patient and your pharmacy software system tells you that there is an interaction between the two medications. If you do not understand the interaction, would you be able to make a decision on whether the interaction is significant? Would you understand if there needs to be a change in therapy?

If you don't understand your financial statements, would you be able to draw your own conclusions on the health of your pharmacy? Would you be able to make educated decisions to optimize the financial health of your pharmacy?

To understand more about financial statements, we will outline what balance sheets and income statements are and how they are used in managing a pharmacy's finances.

**APPROVED FOR 2 CE UNITS**

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**ANSWERING OPTIONS**

1. After carefully reading this lesson, study each question and select the one answer you believe to be correct. Answer online at www.CanadianHealthcareNetwork.ca.
2. To pass this lesson, a grade of at least 70% (11 out of 15) is required. If you pass, your CEU(s) will be recorded with the relevant provincial authority(ies). (Note: some provinces require individual pharmacists to notify them.)

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# Financial Statements

## Balance Sheet

A balance sheet is the starting point for understanding a pharmacy's financial position. It is like a photograph. It provides a snapshot, at a specific point in time, of everything your pharmacy owns (its assets), owes (its liabilities), and how much equity is left over for the shareholders. This snapshot is usually taken at the end of the fiscal year and serves as a summary of the pharmacy's assets, liabilities, and equity.[1]

### HOW THE BALANCE SHEET WORKS

The balance sheet is divided into two parts based on the following equation:


The two parts of the balance sheet must equal each other, or balance each other out.[2]

If you think about your own financial net worth, you have assets such as a home, a car, investments, stocks, and cash in the bank. You also have liabilities or debt such as a mortgage, a car loan, and credit card bills.[3] Your personal assets minus your personal liabilities is your personal net worth. Your financial net worth is akin to shareholders' equity.

Simply put, a balance sheet lists all the assets and liabilities of your pharmacy.

### *Assets*

An asset is something of value that your pharmacy owns that can be converted into cash or is cash in its current form.

Assets are divided into two main groups: current assets and long-term assets. Current assets are assets that are expected to last or be in use for less than one year. They flow through your pharmacy quickly.

Some examples include cash (on hand and in the bank), accounts receivable (any money owed to the pharmacy by third-party plans or customers who have taken medications and not paid for them), and inventory.

Long-term assets are assets that your pharmacy keeps in the same form for a number of years. They don't flow through your pharmacy quickly. Some examples include equipment (computer system, counting machine, compounding equipment), property, and vehicles.[3]

### *Liabilities*

Liabilities refer to the debt or obligations your pharmacy has incurred.

Liabilities are divided into two main groups: current liabilities and long-term liabilities. Current liabilities are liabilities that need to be paid off within one year. Some examples include accounts payable for purchases from your wholesaler and taxes.

Long-term liabilities are liabilities that can be paid off over a longer time. Some examples include mortgages, leases, and loans.[2]

### *Shareholders' Equity*

Shareholders' equity represents a company's total net worth.[2] It is calculated by adding all the pharmacy's assets and subtracting the pharmacy's liabilities.

Shareholders' equity comes from two places. The first is the initial amount of money invested into the pharmacy by the owners. The second is the retained earnings. Retained earnings are the accumulated profit that a pharmacy has made and held onto and not paid out to its owners as dividends.

The left side of the balance sheet lists the pharmacy's assets or capital, and the right side lists who owns the capital—liabilities and equity. On the balance sheet, total assets equal the total liabilities plus shareholders' equity.

We draw up a balance sheet at the end of each financial year. Figure 1 is a sample balance sheet for Pharmacy A.

It is important to look at your balance sheet closely because it is a good picture of the financial health of your pharmacy. It allows you to understand:

- your assets, liabilities, and working capital
- your capacity to pay short- and long-term debts as they become due
- your liquidity
- the increase or decrease in your business value over time

**FIGURE 1:** Sample **Balance Sheet** for Pharmacy A

| As at December 31, 2011 ($) | |
|---|---|
| **ASSETS** | |
| **Current** | |
| Bank and short-term deposits | 60,004 |
| Rx accounts receivable | 25,000 |
| Rx inventory | 180,000 |
| Front-shop inventory | 15,000 |
| Total inventory | 195,000 |
| Prepaid expense | 10,000 |
| **Total Current Assets** | 290,004 |
| **Long Term** | |
| Fixed assets | 175,775 |
| **Total Assets** | **465,779** |
| **LIABILITIES & SHAREHOLDERS' EQUITY** | |
| **Current** | |
| Accounts payable & accrued liabilities | 140,000 |
| **Total Current Liabilities** | 140,000 |
| **Long Term** | |
| Bank loan payable | 205,000 |
| Due to shareholders | 80,000 |
| **Total Liabilities** | 425,000 |
| **Shareholders' Equity** | |
| Capital stock | 100 |
| Retained earnings | 40,679 |
| **Total Shareholders' Equity** | 40,779 |
| **Total Liabilities & Shareholders' Equity** | **465,779** |

## Income Statement

A pharmacy monitors its sales income and expenses continuously, but once a year it presents an annual report that contains a summary of all information related to the pharmacy's income and expenses during the year just concluded. This summary is called the income statement or profit and loss statement.

The income statement shows what income has come into the pharmacy and what expenses have gone out of the pharmacy during the year.

The bottom line of the statement shows the pharmacy's net income or loss.[1]

We draw up an income statement at the end of each financial year. Figure 2 is a sample income statement for Pharmacy A.

It is important to look at your income statement because it is a good picture of the financial health of your pharmacy. It allows you to understand:

- your sales
- each of your expenses as a percentage of your sales
- your gross profit
- your net income or loss

## Reviewing the Balance Sheet and Income Statement

After reviewing the balance sheet and income statement for your pharmacy, do you know:

- how much your pharmacy is really earning on the money it takes in?
- how efficiently your pharmacy is using its capital?
- how profitable your pharmacy's operations are?
- if your pharmacy has enough equity or if it is surviving mostly on borrowed money?
- if your pharmacy has enough cash to pay its employees and suppliers?
- whether you, as an owner, earn enough to be willing to continue investing in the pharmacy in the future?

None of these six questions can be answered easily by looking at absolute numbers on your financial statements. To obtain figures that can really tell you something, we have to perform an analysis of the balance sheet and income statement. We can perform this analysis by using financial ratios and calculations, which will provide you with an insight into your pharmacy's financial condition and operational performance.

There are many financial ratios and calculations that can apply to a pharmacy. During this CE we will review the most common ones. Let's now look at a series of case studies, which will show us how to use ratios and calculations.

**FIGURE 2:** Sample **Income Statement** for Pharmacy A

| For the year ended December 31, 2011 ($) | | % of sales |
|---|---|---|
| Prescription sales | 1,881,800 | 94.1 |
| Front-shop sales | 118,200 | 5.9 |
| **Total Sales** | **2,000,000** | **100.0** |
| Prescription cost of sales | 1,481,800 | 74.1 |
| Front-shop cost of sales | 78,200 | 3.9 |
| **Cost of Sales** | **1,560,000** | **78.0** |
| **Gross Profit** | **440,000** | **22.0** |
| **OPERATING EXPENSES** | | |
| Employee wages and benefits | 240,000 | 12.0 |
| Rent | 24,000 | 1.2 |
| Advertising/marketing | 10,000 | 0.5 |
| Insurance | 6,000 | 0.3 |
| Store supplies | 4,000 | 0.2 |
| Delivery services | 2,000 | 0.1 |
| Computer | 8,000 | 0.4 |
| Utilities | 10,000 | 0.5 |
| Other operating expenses | 106,000 | 5.3 |
| **Total Operating Expenses** | **410,000** | **20.5** |
| Loan interest | 18,900 | 0.9 |
| **Total Expenses** | **428,900** | **21.4** |
| Misc. income (prof. allowances, etc.) | 50,000 | 2.5 |
| **Net Income** | **61,100** | **3.1** |

**Net income or loss** is calculated by taking gross profit and subtracting total expenses and then adding in any miscellaneous income eg, professional allowances.

| Net Income / Loss | = | Gross Profit | - | Total Expenses | + | Misc. Income |
|---|---|---|---|---|---|---|
| $61,100 | = | $440,000 | - | $428,900 | + | $50,000 |

# CASE STUDIES

## CASE STUDY 1: Ratios that Show Your Pharmacy's Cash Flow

Pharmacy A is planning on relocating and expanding from a 3,000 square foot store to a 5,000 square foot store. In order to do this, the pharmacy requires financing from the bank. The bank is collecting information to review the request and wants to know if Pharmacy A:

- is generating enough income to support further investment in it
- has enough funds to pay off its current debt
- is efficient with collecting its accounts receivable

To answer these questions, we need to analyze Pharmacy A's net operating income % and cash flow. Cash flow analysis uses ratios that focus on cash flow and how solvent, liquid, and viable the pharmacy is.

Let's start by reviewing the net operating income % for Pharmacy A.

**NET OPERATING INCOME %:** This calculation shows us how much net operating income Pharmacy A is generating from its sales.

The values for net operating income (net income) and annual sales (total sales) are from Pharmacy A's income statement (Figure 2).

For Pharmacy A, the **net operating income %** =

| Net Operating Income % | = | Net Operating Income | ÷ | Annual Sales | X | 100 |
|---|---|---|---|---|---|---|
| 3.06% | = | $61,100 | ÷ | $2,000,000 | X | 100 |

This calculation shows that every $100 in sales results in $3.06 in net operating income after all expenses are paid for at Pharmacy A.

The bank reviews the 2011 National Community Pharmacist Association Digest and feels that the net operating income being generated is low and continues to analyze the cash flow.[4]

**CURRENT RATIO:** This ratio is used to determine Pharmacy A's liquidity.[5] It will tell the bank if Pharmacy A's current assets are sufficient to meet its current debt.

The values for current assets and current liabilities for Pharmacy A are obtained from the balance sheet (Figure 1).

For Pharmacy A, the **current ratio** =

| Current Ratio | = | Current Assets | ÷ | Current Liabilities |
|---|---|---|---|---|
| 2.07 | = | $290,004 | ÷ | $140,000 |

This ratio shows that Pharmacy A has $2 in cash or equivalent assets to pay every $1 of current debt. This may be good, as it seems as though Pharmacy A has the ability to pay off its debt with its assets. A ratio equal to or greater than 2.0 is considered good for pharmacy.[6]

A pharmacy may have a strong current ratio, but much of its assets may be tied up in inventory, which may not be able to be converted into cash quickly enough to pay off any debt. This is why it's important when looking at cash flow to also look at another ratio—the quick ratio.

**QUICK RATIO:** This is a calculation of Pharmacy A's liquidity without taking inventory into account.[5] This ratio is a more conservative test of Pharmacy A's ability to meet its current debt.

The values for cash (bank and short-term deposits, security deposit), accounts receivable, and current liabilities are obtained from the balance sheet (Figure 1).

For Pharmacy A, the **quick ratio** =

| Quick Ratio | = | Cash + Accounts Receivable | ÷ | Current Liabilities |
|---|---|---|---|---|
| 0.68 | = | $95,004 | ÷ | $140,000 |

The ratio shows that Pharmacy A has $0.68 in cash or equivalent assets to pay every $1 of current debt. This means that Pharmacy A has to sell inventory to meet its short-term debt, which may not be a good position for the pharmacy to be in.

A ratio greater than or equal to 1.60 is considered the minimum to be profitable.[4]

The bank suggests that Pharmacy A should improve its quick ratio by:

- ensuring that bank deposits are made on a regular schedule
- using a high-interest account to keep any excess cash balance; move this into the operating account when needed
- negotiating longer payment terms when purchasing inventory if there is no incentive for prompt payment

**RX ACCOUNTS RECEIVABLE TURNOVER (DAYS):** This is a calculation of Pharmacy A's ability to collect credit revenue. This calculation measures how quickly the pharmacy collects revenue from third-party payers and customers with accounts.

The value for Rx accounts receivable is from the balance sheet (Figure 1). The annual credit Rx sales are $495,000.

For Pharmacy A, the **Rx accounts receivable turnover (days)** =

| Rx Accounts Receivable Turnover (Days) | = | 365 | X | Rx Accounts Receivable | ÷ | Annual Credit Rx Sales |
|---|---|---|---|---|---|---|
| 18.43 | = | 365 | X | $25,000 | ÷ | $495,000 |

The ratio shows that Pharmacy A has been able to collect revenue from third-party payers and customers with accounts within 18.43 days, which is efficient.

Pharmacy A maintains an efficient accounts receivable by:

- setting a credit limit for all its customers
- recording its customers' credit card details for outstanding payments
- getting a deposit for any prescriptions that cannot be reallocated once prepared (eg, specialty compounds)

After reviewing these ratios, the bank concludes that Pharmacy A has enough assets to cover its debt and is efficient with its accounts receivable. The bank has a concern with the net profit the pharmacy is generating from its sales. After reviewing the business plan for the expansion, the bank understands that the new location will have better visibility and parking and will include a high-profit compounding centre. The projected net profit % after the expansion grows to 6% after two years. After taking all these factors into consideration, the bank decides to finance the expansion.

## CASE STUDY 2: Ratios that Highlight the Profitability of Your Pharmacy

Tom Smith is a pharmacist who has been managing a corporate pharmacy for the past five years. He has saved up some money and wants to buy a pharmacy. Pharmacy A is up for sale and he wants to know if it is profitable.

To answer this question, we need to analyze the profitability of Pharmacy A by reviewing three common profitability ratios and calculations. These should be reviewed for at least the past three years so that Tom can see a trend for the pharmacy.

**SALES TO ASSETS RATIO:** This ratio shows Pharmacy A's efficiency in managing its assets in relation to its sales.

The value for sales revenue is from Pharmacy A's income statement and the value for total assets is from its balance sheet (Figures 2 and 1).

For Pharmacy A, the **sales to assets ratio** for 2011 =

| Annual Sales to Total Assets | = | Annual Sales | ÷ | Total Assets |
|---|---|---|---|---|
| 4.29 | = | $2,000,000 | ÷ | $465,779 |

In 2010 it was 4.00 and in 2009 it was 3.90.

This ratio shows that every $1 of assets at Pharmacy A generates $4.29 in sales.

The average community pharmacy had a ratio of 5.2 in 2010.[4] This means that every $1 of assets generated $5.20 in sales.

***DISCUSSION***

Tom realizes that the assets of Pharmacy A are okay, but have room for improvement. He also understands that the ratio has been increasing since 2009. He would like a higher ratio as this means that a smaller investment in assets will be required to generate sales revenue. A higher ratio will result in greater profitability for Pharmacy A.

Tom decides that if he purchases Pharmacy A, he could improve this ratio by:

- increasing sales while maintaining its current assets, for example by introducing expanded services
- buying used or leased pharmacy equipment before buying anything new
- reducing inventory, for example, returning expired inventory to vendors on a regular basis

**DEBT TO EQUITY RATIO:** This ratio shows how much debt the pharmacy has in relation to its equity.

The values for total liabilities and shareholders' equity are from Pharmacy A's balance sheet (Figure 1).

For Pharmacy A, the **debt to equity ratio** for 2011 =

| Debt to Equity Ratio | = | Total Liabilities | ÷ | Shareholders' Equity |
|---|---|---|---|---|
| 10.42 | = | $425,000 | ÷ | $40,779 |

In 2010 it was 11.20 and in 2009 it was 11.50.

The ratio shows that Pharmacy A has high debt and is heavily dependent on creditors.

***DISCUSSION***

Tom consults with his accountant who explains that Pharmacy A has a high debt to equity ratio mainly because it is a fairly new pharmacy and still in a growth phase. His accountant explains that this ratio will go down as sales increase and more debt is paid off. He also explains that the ratio has improved since 2009 when the pharmacy opened.

**NET OPERATING INCOME %:** This calculation shows how much net operating income Pharmacy A is generating from its sales.

The values for net operating income (net income) and annual sales (total sales) are from Pharmacy A's income statement (Figure 2).

For Pharmacy A, the **net operating income %** for 2011 =

| Net Operating Income % | = | Net Operating Income | ÷ | Annual Sales | X | 100 |
|---|---|---|---|---|---|---|
| 3.06% | = | $61,100 | ÷ | $2,000,000 | X | 100 |

In 2010 it was 3% and in 2009 it was 2.95%.

This calculation shows that every $100 in sales results in $3.06 in net operating income after all expenses are paid for at Pharmacy A.

The average pharmacy had a ratio of 3% in 2010.[4]

***DISCUSSION***

Tom understands that the higher the percentage, the more efficient and profitable the pharmacy is. His accountant says that 3.06% is in the average range for a pharmacy. He says that there has been marginal improvement since the pharmacy opened in 2009. He explains that the pharmacy has lots of potential to increase its net profit % to greater than 6%, which would be a good return.

Tom's accountant suggests that Tom can increase the net operating income by:

- increasing profit while maintaining current sales
- maintaining current sales volume while decreasing controllable operating expenses such as:
  - wages and benefits
  - utilities
  - advertising and marketing
  - store supplies

Tom concludes that overall Pharmacy A is not very profitable; however, he sees lots of room to improve the profitability.

## CASE STUDY 3: Ratios that Highlight Efficiencies at your Pharmacy

Tom wants to know how efficient Pharmacy A has been. He wants to know if there is room to improve on efficiency. We suggest that he reviews some efficiency ratios and calculations for Pharmacy A.

We will review three ratios and calculations to give Tom a better idea of the efficiency of Pharmacy A.

**INVENTORY TURNOVER RATE:** This calculation shows how efficient Pharmacy A is at selling its inventory.

The values for annual cost of sales and average inventory are from Pharmacy A's income statement and balance sheet (Figures 2 and 1).

For Pharmacy A, the **inventory turnover rate** =

| Inventory Turnover Rate | = | Annual Cost of Sales | ÷ | Inventory |
|---|---|---|---|---|
| 8.0 | = | $1,560,000 | ÷ | $195,000 |

The ratio shows that Pharmacy A sold and replaced its inventory eight times during the fiscal year.

The average community pharmacy had a calculation of 11.60 in 2010.[4]

***DISCUSSION***

Tom sees that Pharmacy A has an inventory turnover rate that is in the caution area. He understands that this is partly due to the fact that it is a new pharmacy, which needed to have adequate inventory in place from opening day. His accountant tells him that as sales increase, the pharmacy's inventory turnover rate will also increase.

Tom's pharmacist owner friend also gave him some tips on how he could reduce the inventory level at Pharmacy A:

- return any expired prescription inventory to vendors on a regular basis
- increase prescription and front-shop sales while maintaining current inventory levels
- lower inventory levels by using automated replenishment, which is available on most pharmacy software programs

**FRONT-SHOP GROSS MARGIN RETURN ON INVENTORY:** This calculation shows how much gross profit the pharmacy's front-shop inventory is generating.[7] This calculation is important because it will let Tom know if the front shop is efficient in generating gross profit.

Annual front-shop gross profit is calculated by subtracting the front-shop cost of sales from the front-shop sales, both of which are from Pharmacy A's income statement (Figure 2). Front-shop average inventory is the front shop inventory value from Pharmacy A's balance sheet (Figure 1).

For Pharmacy A, the **front-shop gross margin return on inventory** =

| Front-Shop Gross Margin Return on Inventory | = | Annual Front-Shop Gross Profit | ÷ | Front-Shop Average Inventory | X | 100 |
|---|---|---|---|---|---|---|
| 267% | = | $118,200 – $78,200 | ÷ | $15,000 | X | 100 |

The calculation shows that at Pharmacy A, every $1 of inventory generates $2.67 of gross profit over the year.

***DISCUSSION***

Tom understands from this calculation that the front shop merchandise at Pharmacy A is profitable.

He interviews the current front-shop manager who explains to Tom that she:

- keeps inventory levels low by reviewing re-order points, eg, if she sells one bottle of Vitamin B per week, she sets her re-order parameters to order another one when she is left with one on the shelf
- also lowers inventory levels by reviewing the safety stock parameters she has set (safety stock is the amount of extra inventory you carry on your shelf)
- ensures that planograms are updated with new products at least once per year, which ensures that the newest items are on the shelf

**SALES PER SQUARE FOOT:** This calculation shows how efficient the pharmacy floor space is in generating sales.

The value for annual sales (total sales) is from the income statement of Pharmacy A (Figure 2).

For Pharmacy A, the annual **sales per square foot** =

| Sales per Square Foot | = | Annual Sales | ÷ | Pharmacy Square Feet |
|---|---|---|---|---|
| $666.67 | = | $2,000,000 | ÷ | 3,000 |

The average community pharmacy had sales of $1,168 per square foot in 2010.[4]

***DISCUSSION***

Tom's accountant explains to Tom that Pharmacy A is not efficient with its space. He tells him that if he purchases the pharmacy he would need to work to bring sales up to at least $1,195 per square foot.

There are many ways Tom could impact this ratio. Some examples include:

- increasing front-shop sales by introducing and marketing a niche category, eg, home healthcare, homeopathic medication, or ostomy supplies
- increasing prescription sales by introducing immunization services
- subleasing 1,500 square feet to a doctor's clinic

Tom concludes that Pharmacy A has lots of room to improve on its efficiency.

## CASE STUDY 4: Calculation of Prescription Margin Needed to Compensate for Losses in Profitability

Linda is the current owner of Pharmacy A. She knows that with the new drug reform, she is going to lose $40,000 in professional allowances this year. She wants to know how she can make up this loss from her current prescription business.

To answer Linda's question, we need to look at how much gross profit her current prescription business is generating.

Linda's current gross profit for prescriptions = prescription sales revenue – prescription cost of goods sold. The values for each are from the income statement of Pharmacy A (Figure 2). Her annual gross profit for prescriptions is $1,881,800 – $1,481,800 = $400,000. The value for annual prescription sales is from the income statement of Pharmacy A (Figure 2).

For Pharmacy A, the **gross profit percentage** =

| Rx Gross Profit (%) | = | Annual Rx Gross Profit | ÷ | Annual Rx Sales | X | 100 |
|---|---|---|---|---|---|---|
| 21.26% | = | $400,000 | ÷ | $1,881,800 | X | 100 |

To make up the loss from professional allowances, she will have to add $40,000 to her prescription gross profit.

Her new gross profit percentage will need to be ($440,000 ÷ $1,881,800) x 100 = 23.38%.

***DISCUSSION***

Some suggestions for Linda to achieve this are to:

- increase prescription gross profit by increasing expanded service offerings; these services typically have a higher gross profit than prescriptions
- review the current dispensing fee and determine if there is any room to increase

## CASE STUDY 5: Am I Overspending or Underspending on Wages?

Cheryl is the new human resource manager for Pharmacy A. She wants to evaluate the efficiency of the staff at Pharmacy A. To help Cheryl, we will look at the following calculation.

**ANNUAL WAGE COST AS A % OF ANNUAL GROSS PROFIT:** This calculation shows how much money in wages and benefits were spent to achieve the pharmacy's gross profit.

Total wages and benefits cost as well as total gross profit can be obtained from Pharmacy A's income statement (Figure 2).

For Pharmacy A, the **annual wage cost as a % of annual gross profit** =

| Annual Wage Cost as a % of Annual Gross Profit | = | Annual Wage Cost | ÷ | Annual Gross Profit | X | 100 |
|---|---|---|---|---|---|---|
| 54.55% | = | $240,000 | ÷ | $440,000 | X | 100 |

***DISCUSSION***

This value of 54.55% means that it costs $54.55 in wages to generate $100 in gross profit. According to Cheryl, the pharmacy should ideally be at a value of 45%. As a first step, she plans to get the wage spend down to 51.28% during the next 12 months.

Cheryl has the following plan to achieve this: She would like to have the pharmacist spend more time with expanded services such as medication reviews, diabetes education, and the quit smoking program offered at the pharmacy. These will generate a higher gross profit. As an example, if they add one medication review, one diabetes education session, and one smoking cessation session five days of each week, they will generate an additional $180 in gross profit per day or $3,600 per month and $43,200 annually. To ensure that the pharmacist has time to conduct these expanded services, the pharmacy will use a regulated technician to take over some of the pharmacist's current dispensary functions like transfers, verbal prescriptions, and signing off on blister packs. A regulated technician will increase the wage spend by $7,800 per year compared to the current wage spend on pharmacy assistants. If these targets can be achieved within 12 months, the pharmacy will spend $247,800 on wages and achieve a gross profit of $483,200.

This will bring the annual wage cost as a % of gross profit to ($247,800 ÷ $483,200) x 100 = 51.28%.

This will be an improvement of 3.27% in year one.

## CONCLUSION

The pharmacy business model has changed drastically over the past few years and will continue to change for years to come. Our profession is experiencing constant growth with the introduction of new and expanded services. All these changes will affect the financials of our practice. It is critical that you understand your financials as this will help you keep your practice financially successful.

A financial review allows your pharmacy to thrive and succeed in a changing world. If you need assistance, use the Teva Business Checkup app, which is a free tool available at www.tevabusinesscheckup.com. Export the information and review it with your accountant or financial advisor. Review trends from year to year to see how you are progressing.

## QUESTIONS

Please select the best answer for each question or answer online at **www.CanadianHealthcareNetwork.ca** for instant results.

1. A balance sheet is a financial statement that is a record of:
a) assets and liabilities
b) assets, liabilities, and shareholders' equity
c) fixed assets and current liabilities
d) current assets and long-term liabilities

2. On a balance sheet which of the following is true?
a) assets = liabilities – shareholders' equity
b) liabilities = assets + shareholders' equity
c) assets = liabilities + shareholders' equity
d) shareholders' equity = assets + liabilities

3. Which of the following is an example of a fixed asset?
a) property
b) cash in the bank
c) inventory
d) accounts receivable

4. Which of the following is an example of a current asset?
a) vehicle
b) computer
c) counting machine
d) inventory

5. Which of the following is an example of a current liability?
a) mortgage
b) bank loan with a payment due date of longer than one year
c) accounts payable
d) accounts receivable

6. Which of the following is an example of a long-term liability?
a) bank loan with a payment due date of less than one year
b) accounts payable
c) taxes
d) mortgage

7. What is the definition of retained earnings?
a) It is the accumulated profit that a pharmacy has made, held onto, and not paid out to its owners as dividends.
b) It is earnings that have been retained by the government for tax purposes.
c) It is earnings that have been retained by the bank to secure a loan.
d) It is the accumulated profit that a pharmacy has made and paid out to its owners as dividends.

8. Which of the following can be found on an income statement?
a) assets and liabilities
b) shareholders' equity
c) total expenses
d) capital stock

9. Which of the following statements is true regarding the "bottom line" of the income statement?
a) On this line, you will find the total expenses of the pharmacy.
b) On this line, you will find the total sales of the pharmacy.
c) On this line, you will find the net profit or net loss of the pharmacy.
d) The lower the value, the more profitable the pharmacy.

10. Which of the following is the correct calculation for the current ratio?
a) current ratio = current assets ÷ long-term liabilities
b) current ratio = current liabilities ÷ current assets
c) current ratio = fixed assets ÷ current liabilities
d) current ratio = current assets ÷ current liabilities

11. A debt to equity ratio of 5 means which of the following for a pharmacy?
a) For every $1.00 of debt, the pharmacy has $5.00 of equity.
b) For every $1.00 of net worth, the pharmacy has $5.00 of debt.
c) The equity of the pharmacy is 5%.
d) The debt of the pharmacy is 5%.

12. An inventory turnover rate of 8 means which of the following for a pharmacy?
a) It would take eight years for the pharmacy to sell its inventory.
b) It will sell its inventory eight times this month.
c) It sold its inventory eight times during the last fiscal year.
d) It bought inventory eight times last month.

13. A pharmacy has a front-shop gross margin return on inventory of 225%. Which of the following statements is true?
a) The front-shop merchandise at the pharmacy has a gross profit of 225%.
b) For every $1.00 of inventory, the pharmacy generates $2.25 of gross profit.
c) The pharmacy's inventory increased by 225%.
d) The pharmacy's inventory resulted in a 225% increase in sales.

14. A pharmacy has a prescription gross profit of 22%. Which of the following statements is false?
a) If the pharmacy grows its gross profit to 25%, it would be more profitable.
b) Every $100.00 of prescription sales generates $22.00 of gross profit.
c) If the pharmacy reduces its gross profit to 20%, it would be more profitable.
d) Prescription gross profit is calculated by taking the total prescription selling price and subtracting the cost of the medication.

15. A pharmacy spends 50% of its gross profit on wages. Which of the following statements is true?
a) The pharmacy should reduce its wage spend as the average pharmacy spends 45% of its gross profit on wages.
b) The pharmacy should increase its wage spend as the average pharmacy spends 55% of its gross profit on wages.
c) The higher the percentage of gross profit spent on wages, the greater the efficiency of the pharmacy.
d) The pharmacy can reduce its spend on wages to 45% of gross profit by decreasing its gross profit.

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## CE FACULTY

### Understanding a Pharmacy's Financial Statements and How to Analyze Them


**About the authors**

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**Reviewers**

Reviewed by David Cunningham, BMath, CMA, CA.

All lessons are reviewed by pharmacists for accuracy, currency and relevance to current pharmacy practice.

This lesson is valid until July 5, 2015. Information about understanding a pharmacy's financial statements and how to analyze them may change over the course of this time. Readers are responsible for determining the most current aspects of this topic.

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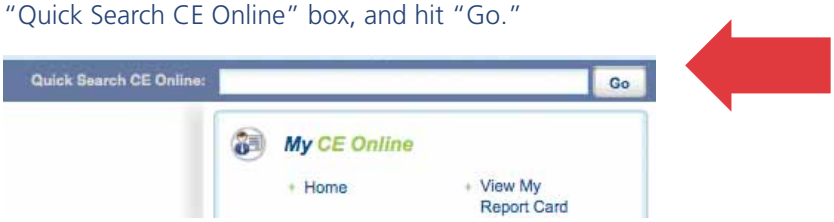


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