YOUR PRACTICE'S FINANCIAL PERSPECTIVE: MANAGERIAL VS. TAX
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On the surface, managerial accounting versus tax accounting may not seem relevant to your practice. But if we take the time to explain them just a bit, you will quickly see how the two perspectives are different – and why they are both very important for your practice!

Managerial Accounting – is recording numbers and data in a way to measure, analyze, interpret and communicate information to owners and managers regarding the practice's operations for the purpose of achieving the practice's goals. That's a long-winded way of saying this method helps you manage your practice; hence the name, "managerial." This type of accounting uses the accrual based accounting method. If you read our previous newsletters, you will remember that the accrual method records transactions when they are incurred, which allows revenue to be matched with the expenses required to generate that revenue. Managerial accounting is used primarily for internal reporting purposes to help practice owners and managers identify opportunities and to isolate efficiency issues that reduce profits. It's also important when determining a value or purchase price for the practice.

Tax Accounting – focuses on recording transactions for the sole purpose of preparing tax returns based on Internal Revenue Code guidelines. Since it's specifically for tax reporting purposes, this method is considered "external" reporting. For small businesses, tax accounting is done on a cash basis, which means transactions are recorded when cash is actually exchanged. Tax accountants work very hard to lessen the tax burden on a practice owner, which translates to minimizing profits. Recording discretionary expenses, above market rent paid to yourself, overpaying family members, or buying a lot of capital equipment at year-end are all strategies used to save tax dollars, which in turn, lowers business profits.

Business owners have fixated on reducing taxes for decades, trained by tax accountants to reduce profits in order to save taxes. Now, we challenge you to a new way of thinking. Show some profits on the tax return! Yes, your tax burden might increase, but it will also increase practice value by much more.

Here is a great example to illustrate the two different perspectives:

> From a tax point of view, if you have a $1,000 tax deduction or a "perk" item in your annual expenses, the tax on that amount would be about 25% - 45%, depending on your tax bracket. So the amount you would save in taxes by taking that $1,000 deduction would be around $250 - $450.
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> Looking at that example from a managerial standpoint, when determining the value of a practice, every dollar that makes it to the bottom line on the profit and loss statement will increase a practice's value. Typically, the value will increase by about $4 -$7 dollars. So, if you did *not* take that $1,000 deduction, the $250 - $450 tax dollars you paid becomes an excellent investment, returning $4,000 - $7,000 in increased practice value!

To share another example, we have seen many financial statements that have been adjusted or "smoothed" by tax accountants to create consistent spending patterns from year to year so as not to attract attention from the IRS. This practice is not necessarily incorrect. The CPAs don't change the bottom line; they just move expenses into different categories. However, if you want to understand why the company is struggling with low profits, the tax accountant's changes have covered up issues that would normally "stick out." From a managerial accounting perspective, you need to be able to identify unusual spending and research those items to manage the underlying issues accordingly.

Tax accounting is very important, make no mistake! So is a tail on a dog. But it is important not to let the "tail wag the dog." Tax accounting has very little to do with helping you operate your hospital and everything to do with reporting income and paying (or not paying) taxes.

To be clear, we are NOT recommending keeping two sets of books! It is possible to utilize both accounting methods; you don't have to use only one or the other. Start by using a veterinary specific chart of accounts. The AAHA/VSG Companion Animal Chart of Accounts[1] was developed with input from veterinary accountants. Adopting this within your QuickBooks file or other bookkeeping software allows for easier managerial accounting, all the while keeping in mind the categories that tax preparers need for tax planning and preparation. Practice owners and managers are thrilled to get more information out of their financials – information they can use to measure and manage operations. Tax accountants are happy to get the information they need easily. Likewise, consider where your practice is in its life cycle. If you are 3 - 5 years from selling your practice, focusing more on managerial accounting that can help you build value would be advantageous. New practices that are growing rapidly may prefer to keep tax liabilities at a minimum.

When managing your hospital's finances, understanding the tax consequences of a decision should always be considered, but that shouldn't be the *only* thing you consider. By understanding the different perspectives of tax versus managerial accounting, you can make intelligent business decisions based on accurate financial data.

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[1] https://www.aaha.org/professional/resources/chart_of_accounts.aspx