

# Fixed Costs and Variable Costs

It's important to know the differences.

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**I**t is essential to understand that there are two types of costs to consider when making decisions regarding volume or pricing—fixed and variable ones. Most data we receive from our accountants gives us only average and total costs. Average and total cost numbers combine both fixed and variable costs together. For most of the practice decisions we will be making—such as short-term pricing and contracting decisions that will alter patient volume—the variable costs are the ones that will be relevant. Variable costs are the existing costs that will change as a direct result of implementing specific decisions.

Fixed costs, on the other hand, are the ones that are not going to be altered by a specific decision. They are a result of previous decisions that have been made and are not going to change as a result of any new decision. Fixed costs should not be a factor when determining what changes

you want to make. Using fixed costs when making short-term, strategic, financial decisions leads to poor financial choices—especially when the choice involves whether or not to accept a contract that will increase patient volume.

For example: assume that a doctor with a practice grossing \$200,000

The doctor's accountant analyzes the contract and recommends that it be rejected because, as he tells the doctor, "You will lose money." He explains that the practice overhead (\$120,000) is 60 percent of total revenues and that the doctor had 4,000 patient visits last year (80 a week). From these figures, he calculates the

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a year is considering signing a contract that will increase patient volume by 2,000 visits a year. The contract will add revenue of \$25 per patient and, therefore, should increase revenue by \$50,000. Before accepting the contract, the doctor needs to determine the cost of treating these additional patients.

average cost per patient to be \$30 and informs the doctor that with the new contract's revenue of only \$25 a patient, s/he would be losing \$5 a patient.

While there may be other reasons for rejecting this contract, lack of profitability should not be one of them. Otherwise intelligent people often make this type of mistake. The problem is that fixed costs have not been correctly accounted for in making this decision.

Assume that the doctor will be able to accommodate the additional 2,000 patient visits (8 a day) without adding costs for more space or hiring additional employees. Further, assume that there is an average \$3 supply cost for each patient (\$6,000 for 2,000 patients). For pur-

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TABLE I:

## Calculating Contract Profitability

	Revenue	Overhead	Profit	% Profit Increase
<b>Without Contract</b>	\$200,000	\$120,000	\$80,000	
<b>Changes Under Contract</b>	+ \$50,000	+ \$6,000	+ \$44,000	
<b>With Contract</b>	<b>\$250,000</b>	<b>\$126,000</b>	<b>\$124,000</b>	<b>55%</b>

*Costs (from page 153)*

poses of this contract decision, rent, salaries, malpractice premiums, automobile expenses, telephone costs, and other expenses should not change. In other words, for purposes of this decision, these are all fixed expenses that should not enter into the decision-making process because they will need to be paid whether or not the doctor accepts the contract.

By considering only the relevant variable costs (i.e., supply costs), the doctor determines that this contract will not produce a loss. Instead, it should increase profit by \$44,000, a 55% increase for this practitioner! This is demonstrated in Table 1.

If the doctor determines that treating these additional patients will require hiring one more employee, that employee's salary becomes a variable cost and is relevant to making the decision as to whether or not s/he should accept the contract. (The

amount of this new salary would be added to the overhead/changes under contract entry in Table 1).

Confusion is created when some costs that we traditionally see as "fixed" become "variable" because of a particular change we are considering—such as the change in the number of employees in the example above. Another example: when making a decision regarding change in a practice, rent is usually considered a fixed expense; however, if a contract or merger is being considered which will increase patient volume to the point that the practice will require additional space, any resultant increase in rent becomes a variable cost, and is therefore relevant to the decision being made. The amount of the rent increase is added to the variable costs at this point. If the current rent is \$3,000 a month and the new rent would be \$4,500 a month, the original \$3,000 cost remains as a fixed expense

while the \$1,500 increase becomes a variable expense for purposes of this decision.

Making bad financial decisions is not only costly, but can result in lost opportunities. The starting point for evaluating any financial decision should be to identify those costs that will remain fixed and those which will become variable for that specific decision. This type of analysis will provide you with consistently better and more accurate information needed to make financial decisions about your practice. **PM**



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