Costs Significant to Contract and Merger Decisions

Variable costs are key to your financial analysis.

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We have all heard, "It's not how much you make that counts; it's how much you keep." Let us consider the wisdom of this maxim as it relates to the medical practice. Although top line revenue for today's typical practice remains relatively high, the portion that drops to the bottom line as profit continues to shrink. This is partly due to lower fees, but doctors today are facing challenges greater than decreasing fees, and these are high patient volumes and more complex business operations—both of which result in overly high costs. This circumstance has propelled us to examine costs more closely and better understand which costs are relevant in the decision-making process. We can wield this understanding in a way that achieves ultimate success.

Revenue and Costs are the two key elements that determine profit, which is defined as revenue minus cost. The equation for this is: **Profit = Revenue – Cost.** The critical thing to understand about this equation is that when making financial decisions, we are not dealing with one, but two, types of costs—both fixed and variable. In order to accurately determine profit, we need to "tweak" the equation: **Profit = (Price x Volume) – (Fixed Costs + Variable Costs).**

It is the differentiation between the two types of costs that is one of the most critical factors to understand when making decisions involving changes in volume or pricing. Most data we receive from our accountants give us average as well as total costs, but both average and total cost numbers typically combine fixed and variable costs together. For most of the decisions we will be making—when determining whether to merge a practice or sign a new contract (with discounts that could alter patient volume)—variable costs are the ones that will be essential to our decision. These are the portions of total costs that will change as a direct result of implementing any new strategy that will impact volume.

Fixed costs, on the other hand, will not be altered by most decisions. Because of this, they are not usually a relevant factor when determining which changes you should or should not make. Using these fixed costs when making short-term, strategic financial decisions can lead to poor financial choices, especially when a choice involves whether or not to accept a contract or merge in a practice that will result in increased patient volume. It is best when testing whether new profit will result from decisions being made that we take fixed costs out of the equation, which now becomes: **New Profit = (Price x Volume) – (Variable Costs).**

Using fixed costs when making short-term, strategic, financial decisions can lead to poor financial choices.

An example: A doctor with a practice grossing $400,000 yearly considers signing a contract that will increase practice volume by 2,000 visits a year. The contract will add revenue of $40 per patient visit, thereby increasing total revenue by $80,000. Before accepting the contract based on this revenue alone, the doctor needs to determine the offsetting *cost* of treating these additional patients. In this situation, s/he often turns to the

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practice accountant for advice. It is typical that the accountant analyzes the contract and recommends that it be rejected because, as he tells the doctor, "You will lose money." In this example, he explains that last year's practice overhead was $240,000 (60 percent of total revenues) and that the doctor had seen 5,000 patients (100 a week). From these figures, he calculates the average cost-per-patient to be $48, and because of this calculation, informs the doctor that with the new contract's revenue of only $40 per patient, s/he would be losing $8 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 the same mistake that has been made here. What the accountant has overlooked is that in making this decision, he has kept the fixed costs—which are irrelevant—in the equation when determining the change in profit that these additional patients will create.

The following is how the practice should examine this opportunity. Assume that the doctor will be able to accommodate the additional 2,000 patient visits (8 a day) without a need for adding office space or staff, either of which would increase fixed costs. Further, assume that there is an average $5 supply cost for each patient (a total of $10,000 *variable costs* for these 2,000 patients). For purposes of this contract decision, the fixed costs—rent, salaries, malpractice premiums, automobile expenses, telephone costs, and other expenses will not be changing, and so, for purposes of this decision, they should not enter into the decision-making process. These expenses will need to be paid whether or not the doctor accepts the contract. By considering only the relevant costs (i.e. the variable ones—any new ones incurred because of these new patients), the doctor determines that this contract will actually produce an increase of $70,000 (a 44% increase) in profit rather than a loss. This is demonstrated in Table 1.

If the doctor determines that treating these additional patients will require hiring one more employee, the increase in salary for this employee *is* relevant to making the decision as to whether or not s/he should accept the contract. That employee's salary will then be added to the variable costs for this decision. In Table 1, the amount of this new salary would be added to the *"overhead/changes under contract"* entry. The contract's profit-

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TABLE 1:

Calculating Contract Profitability

	Revenue	Overhead	% Profit Profit	Increase
Without Contract	$400,000	($240,000)	$160,000	
Changes Under Contract	+ $80,000	($10,000)	+ $70,000	
With Contract	**$480,000**	**($250,000)**	**$230,000**	**44%**

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ability would then be dependent on this new variable cost number, which includes the amount of this new salary.

Another example: When making a decision regarding change in a practice, rent too is another expense usually considered to be fixed; however, if a contract or merger is being considered which will increase patient volume to the point where the practice will require additional space, any resultant *increase in rent* is relevant to the decision being made. In this case, the amount of the potential *increase* in rent is then added to the variable costs. If the current rent is $5,000 a month, and the new rent will be $7,500 a month, the original $5,000 cost remains as a fixed

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expense and is irrelevant to the decision while the $2,500 increase becomes part of the variable expenses and should be inserted as such into the formula when determining profitability.

When analyzing volume change decisions such as practice mergers "under one roof" or discount contracts that will increase patient volume, you can think of your office as an airplane. If you recognize that you have some "empty seats"—such as unfilled treatment rooms or openings in your patient schedule—a contract or merger being considered is intended to supply your practice with those additional patients who will fill them. If you have the necessary staff and space, your costs for rent, staff, malpractice insurance, equipment, and most other expenses are irrelevant for making this decision because they will remain fixed. In this case, the only cost that you will need to consider when estimating whether or not a contract will be profitable or a merger make sense is the variable expense of the medical supplies that will be needed to treat the additional patients that the change will bring in. This is obviously not an exact science; however, if you understand the implications that variable and fixed costs have in this airline analogy, you will be able to make significantly better profit estimates when making financial decisions. **PM**

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