



The Profit Equation

Improving efficiency is the key to increasing profitability.

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We have all heard the saying, “It’s not how much you make that counts; it’s how much you keep.” Let us consider this maxim in terms of the medical practice. Although top line revenue for today’s typical practice remains relatively high, the amount that drops to the bottom line as profit is consistently shrinking. What is happening? This phenomenon is partly due to decreasing fees, but doctors today are facing even bigger challenges—high patient volumes and more complex business operations, both of which result in overly high costs and decreased patient satisfaction. These circumstances have propelled the effective application of efficiency concepts to the forefront of tools a practitioner must understand and know how to implement in order to achieve ultimate success. Since efficiency has been shown to have a positive impact on both quality of care and profitability, a doctor focusing on efficiency im-

provement will not only increase the quality of his/her practice but will also achieve greater profit as a “by-product” of this focus.

Profit is crucial to the success of every business and is a reflection of the value of its products and ser-

vice. Profit results from supplying a product or service that a customer values and is willing to pay more for than what that product costs to produce. In a price-competitive environment where raising prices may not be an option for producing profit, reducing unnecessary costs (which significantly lower a business’s profit margin—sometimes to the point that the business ceases to exist) can help that business stay afloat and even thrive. To clearly understand the relationships among revenue, cost, and quality, it is helpful to see profit from the perspective of a profit equation.

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Profit is defined as revenue minus cost, and revenue is defined as price times volume. Combining these two definitions, we arrive at the formula: **Profit = (Price x Volume) – Cost**

In a medical practice, revenue is modified by the collection ratio. Including the effect of the collection

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ratio in the above equation, we arrive at the formula:
Profit = (Price x Volume)(Collection Ratio) – Cost

Additionally, “costs” should be separated into two categories—fixed and variable. It is significant that variable costs are the principal ones that increase as volume increases. Adding fixed and variable costs to our equation, we arrive at the expanded formula: **Profit = (Price x Volume)(Collection Ratio) – Fixed Costs – (Variable Costs x Volume)**

This expanded equation provides a “visual” which can help us better understand where to focus any strategy for increasing profit. Increasing price, volume, and/or the collection ratio while holding fixed costs stable all will increase profit. Quality is not specifically included in this equation, but we do know that quality is 1) negatively impacted as the volume and complexity of a practice increase and 2) positively impacted by efficiency improvement. If we focus on utilizing efficiency to improve quality, a by-product of this focus will be that we will also achieve greater profit. This is because efficiency increases revenue while decreasing—or holding constant—the cost portion of the profit equation. Efficiency in several areas of practice has the following impacts:

The collection ratio tends to decline as volume and

complexity increase. Efficiency measures aimed at improving the collection process will increase the collection ratio, resulting in a higher portion of revenue dropping directly to the bottom line as profit.

Fixed costs often increase as volume and complexity increase. A focus on process efficiency helps a practice to better manage increasing volume and complexity and keep fixed costs stable by enabling any growth in volume to be spread over existing fixed costs. If fixed costs remain stable, the only costs that increase along with volume are the variable ones. Note that volume is present in both the revenue and cost portions of our equation. When fixed costs remain constant, the only relevant costs are the much smaller, variable

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ones. With growing volume, holding the fixed costs stable results in an ever greater differential between revenue and costs (since, ideally, only variable costs should be increasing). This results in a substantially higher, per patient, profit margin.

An especially positive impact of increased efficiency is its ability to help a practice maintain quality as volume increases—especially its quality of service. Two significant service areas improved through efficiency measures impact the quality of care as well as patients’ perception of quality. These are 1) speed of access to a practice and 2) length of waits upon arrival at a practice. The resultant higher quality of care and service, in turn, also lead to future practice growth through increased referrals.

Returning to the profit equation, it is clear to see that any attempt to improve profitability solely by increasing volume can backfire. This approach has the potential of simultaneously reducing patient satisfaction, decreasing the collection ratio, and increasing fixed costs. Conversely, a focus on quality through efficiency improvement simultaneously addresses the relevant areas of the profit equation that lead to greater profitability. If we include quality and efficiency as part of the profit equation, we could rewrite it as follows:

**Quality and Profit =
(Price x Volume)(Collection Ratio) – Fixed Costs –
(Variable Costs x Volume) + Efficiency. PM**



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