



# Know Your Relevant Costs Before Making Financial Decisions

Small improvements in your decision-making process will add up over time.

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**M**aking consistently good financial decisions will help you build and maintain a successful podiatric practice. Because the amount of money available to any practice is finite, making tradeoffs among multiple “needs” competing for this scarce resource is sometimes necessary. While there may be good reasons for choosing one path over another, the costs relevant to any financial decision should be determined *before* making that decision. Many sub-optimal choices can be avoided simply by taking this first step in your decision-making process.

Profit & Loss (P&L) Statements—standard in any accounting process—display a practice’s amount of total revenue, amounts in each expense category, and overall profit (or loss). Problems with relying solely on this

standard format are that it typically lists expenses in alphabetical order, and it mixes fixed costs and variable ones together. Alphabetical order of

this statement contains the percentage of the total revenue for each expense. Furthermore, expenses on this statement are broken down into two

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fers no strategic information, and relying on fixed and variable costs combined gives an average cost that can lead to sub-optimal decision-making.

Table 1 is an example practice represented by the fictitious 2019 *Profit and Loss Statement* (P&L). Unlike the typical P&L, the expenses in this statement are arranged not alphabetically, but in descending order from highest to lowest. Additionally,

columns, with fixed costs displayed in one and variables in the other. The reason for differentiating these two cost categories is that a practice should attempt to keep fixed costs unchanged as practice volume varies. Variable costs, on the other hand, will be significant in making changes as they will increase or decrease along with changes in volume.

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Including a few ratios on the P&L will also help to assist with decision-making. Our example statement includes the following noteworthy statistics: total expenses of \$404,100, revenues of \$673,200, 6,600 patients treated, an overhead ratio of 60.0%, a revenue/patient of \$102.00, an average cost/patient of \$61.23, and a marginal

cost/patient of \$11.39. Let us look at how knowing and understanding these cost classifications and financial ratios will assist us in making sound financial decisions for this practice.

### Variable Costs

It is essential for a doctor making any financial decision in a situation which includes an expectation of a change in practice volume

(such as when signing or discontinuing a managed care contract—or when adding an associate) to know and understand the significance of both variable and fixed costs. For example, assume that a doctor in our example P&L statement's practice is considering taking on a contract which is expected to add 400 patient visits to his/her practice each year

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TABLE I:  
2019 Profit & Loss Statement

	Practice Costs	Fixed Costs*	Variable Costs*
<b>REVENUE</b>	\$673,200		
<b>EXPENSES</b>			
Employee Wages	\$187,600	27.9%	
Rent	\$69,400	10.3%	
Medical Supplies	\$28,300		4.2%
Orthotics	\$20,200		3.0%
Insurance	\$17,400	2.6%	
Telephone	\$13,600	2.0%	
Office Supplies	\$11,200		1.6%
Transcription	\$6,900		1.0%
Postage	\$6,800		1.0%
Travel/Entertainment	\$6,400	1.0%	
Computer	\$6,400	1.0%	
Utilities	\$5,800	0.9%	
Maintenance	\$4,800	0.7%	
Miscellaneous	\$4,600	0.7%	
Dues	\$3,400	0.5%	
Professional Fees	\$3,300	0.5%	
License	\$2,400	0.4%	
Repairs	\$2,300	0.3%	
Printing	\$1,800		0.3%
CME	\$1,500	0.2%	
<b>TOTAL EXPENSES</b>	\$404,100		
<b>Patient Volume</b>	6,600		
<b>Overhead ratio</b> (expenses ÷ revenue)	60.0%	48.9%	11.1%
<b>Revenue per patient</b> (revenue ÷ pt. volume)	\$102.00		
<b>Average cost</b> (expenses ÷ pt. volume)	\$61.23		
<b>Average marginal cost</b> (variable cost ÷ pt. volume)	\$11.39		

\*It is important to recognize that certain costs can, at times, be classified as "fixed" and at others as "variable"—depending on the type of decision being made. Staff salaries are an example of such a cost.

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with those visits being reimbursed at \$54.00 each. Such a contract would add \$21,600 in revenue to the practice (\$54.00 x 400 visits). A doctor, or even an accountant, might look at this decision and determine that because the average cost per patient for this practice is \$61.23 and each new contract patient would be reimbursed at \$54.00, the contract should be declined. This decision-maker is assuming that the practice will be losing \$7.23 per patient (\$54.00 - \$61.23). This type of reasoning is based on incorrect assumptions. While there may be other reasons for declining this contract, the fear of losing money should not be one of them. This reasoning is flawed due to the lack of recognition that adding 400 patient visits a year should have no impact on the practice's fixed costs.

The only *significant* costs to consider in determining potential profit from this contract are the six expense categories identified in the P&L statement as *variable*. Only these expenses should be impacted by an increase in volume. The six variable cost categories total \$75,200 which, when divided by 6,600 visits, gives a *marginal cost/visit* of \$11.39. In reality, this contract would “cost” only \$4,558 (400 x \$11.39), not the \$24,492 (400 x \$61.23) that the decision-maker had calculated. Instead of losing \$7.23/patient, the result would be a gain of \$42.61/patient, or \$17,042 in profit (\$21,600 - \$4,558). Profit, not revenue, is the *significant* measure to rely on when evaluating this opportunity. Understanding this concept, the doctor is armed with the information relevant to his/her making an informed decision and can now base this decision solely on the needs of the practice and its capacity to add 400 patient visits utilizing its existing space and staff (in order to keep fixed costs as they are).

Another decision commonly faced by a podiatric physician is whether or not to hire an associate. How can a doctor estimate the financial impact that such a decision might have on his/her practice? Again, let us use the sample P&L above. The practice represent-

ed by this statement has an overhead ratio of 60.0%. A typical doctor in this practice would be likely to assume that because his/her gross profit margin is 40%, an associate who receives 40% of the new revenues s/he generates would offer no *financial* benefit to the practice (because the percentage being paid the associate would be the same as the practice's gross profit margin). This reasoning is faulty because, again, the wrong costs are being used to determine profit. In reality, the mar-

should be in the form of increases in productivity which, in turn, will lead to revenues exceeding the cost of making those expenditures.

Let us look at the question of adding new fixed costs in the form of additional staff. Since revenue is generated in the clinical areas of a practice, any increase in clinical staff that frees up a doctor's time to see more patients or provide necessary services will increase overall productivity and revenue. Say that a practice is considering the addition of one new staff

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ginal cost of 11.1% (which takes into account only variable costs) is the relevant ratio to base this decision on rather than the 60% overhead costs which has been determined combining both fixed and variable costs. As long as fixed costs stay fixed when the new associate is added, only variable costs should increase. These variable costs are then used in determining the *marginal profit* accrued from the new business generated by the associate. This profit calculates to a whopping 88.9% (100.0% - 11.1%)—not 40%! This is what makes the “efficient growth” created by the addition of doctors or practice mergers so attractive.

### **Fixed Costs**

The two highest fixed costs for this medical practice are its staff salaries and rent. Decisions involving an increase in either of these areas should be made carefully because such changes will be relatively permanent. Once a practice has made an investment in its core space and the staffing required to manage its volume, any increase in either should be based solely on thorough analysis. Before making any additions to fixed costs, it should first be determined that the expected benefit from these expenditures will be greater than their accompanying ongoing costs. Benefit from any such expenditures

member to help give the doctor more free time, and the starting salary for the position is \$30,000 a year. Based on our example practice's average revenue/per patient of \$102.00, this doctor would need to accommodate 294 additional patient visits each year to reach the financial break-even point for this salary expenditure. Assuming that the doctor works 230 days each year, this break-even point would require him/her to see only 1.28 additional patients each day. Specific staff positions that a busy podiatric physician seeking additional time for treating patients might consider adding are: 1) a scribe who works directly with the doctor, or 2) an assistant who is able to provide some patient care. In many cases, a back office assistant can serve both roles. The addition of a scribe or back office assistant would, conservatively, free up at least three minutes of a doctor's time, per patient visit. For our sample practice, the doctor averages 28.3 visits/day (6,600 ÷ 230 days). This would free up 86 minutes of productive time each day (28.3 x 3 minutes)—time in which s/he could provide additional care. Since this practice currently averages 3.54 patients/hour (28.3 ÷ 8), these “additional” 86 minutes would provide sufficient time for the doctor to see six more patients each day,

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working at the same pace as before. This additional staff person provides an even greater opportunity for any practitioner or group seeing more than 28.3 visits/day.

### **Converting a Fixed Cost to a Variable Cost**

There are several common situations in which a doctor may want to reduce the fixed costs of his/her practice—when, for example, a practice has no growth opportunities or predictable volume from month to month, or year to year, or when a practice has seasonal variations. Additionally, there may be situations in which it is unclear whether a larger office or a satellite location that a practice is considering acquisition of might attract a sufficient number of patients to cover its costs and generate a profit. One strategy for determining the financial viability of any

of these situations is to see if there is a way to convert any of its fixed costs to variable ones. Such conversions create situations in which certain “fixed” costs, like variable ones, will also increase, or decrease, along with changes in volume. For example, utilizing a billing service will convert the “fixed” expense for billing staff to a variable cost—the practice pays only when it uses the service. Another possibility is opening a satellite location in another doctor’s office where rent will be charged hourly. This will convert two other expenses—both rent and staff—from fixed to variable. The doctor is no longer paying rent and salary expenses during the hours s/he is not working. If office hours are cut to part-time, sharing office space or evolving to a micro-practice are also ways of reducing fixed expenses. When you are facing a decision in which your primary concern is declining volume—whether from a reduction in market demand or a planned

choice to practice part-time—consider strategies such as these that either convert fixed costs to variable ones or reduce fixed costs.

As you face financial decisions in the future, realize and utilize those costs most relevant to making your decisions. Given the large number of such choices we make each year, even a slight improvement in your decision-making process will add up over time—giving assurance that your money and time will be allocated to their greatest advantage. **PM**



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