Hidden Costs in Financial Decisions

When making a decision, always factor in opportunity cost.

BY JON A. HULTMAN, DPM, MBA

When making decisions regarding a business, there are costs to consider that do not appear on financial statements. Every time we make a decision, we choose between alternatives, and there are always tradeoffs when choosing one alternative over another. These tradeoffs—known as opportunity costs—are present in all financial decisions, regardless of whether those decisions have to do with personal or practice matters. For example, of one of my early residents who made a decision regarding an automobile. He had just completed his residency and begun practicing as an employed podiatric physician in a private practice. We were meeting for dinner when he showed up driving a flashy new car.

I inquired as to how much he had paid for the car, and his reply was, "$35,000" (expensive at the time—about 30 years ago). I explained to him that $35,000 was not the *actual* cost of the car. His oversight was that he had not factored in the opportunity cost of buying this car as opposed to buying a used one for $5,000 and then investing the difference. Had he invested the $30,000 difference in a stock portfolio at his age of 28, and had that portfolio averaged the stock market's annual return rate of 10%, he would now, at his current age of 62, have almost $700,000 in that portfolio. This was the opportunity cost of this one decision he had made—to buy a depreciating, rather than an appreciating, asset.

Similar outcomes can be achieved from decisions involving our practices. Often, the tradeoffs are not as obvious. For example, when we choose to schedule a procedure from 8:30 to 10:30, we should consider the other types of patient care that could take place between those hours. Or, when considering the addition of space to our business office, we should consider the alternative of using that same space for patient treatment. Making practice decisions requires tradeoffs, and so before going forward, we should do our best to quantify those tradeoffs.

One measure of the cost of a decision is the amount of *profit* or *time* that might be lost as a result of that decision—profit that would have been earned, or time that would have been gained, had an alternative choice been made. This value is known as the *opportunity cost* of a decision, and it is incurred even when no money is spent. Opportunity cost will not show up on a Profit & Loss Statement, but it should be considered when making any practice decision regarding the use of time, space, or capital.

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Likewise, performing one function in a practice is always at the exclusion of other possible choices. For example, if a back-office assistant is rooming a patient, he or she cannot be changing a dressing or taking an x-ray at that same time. In some

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cases, having a doctor with free time perform such a "simple" function may be the most valued opportunity for a practice. A dollar amount can always be put on "the best alternative foregone," and obviously, one's time should always be spent on the highest valued opportunity. Some choices involving opportunity costs are made "on the spot," and others are the result of extensive analysis and planning. It is especially important to ascertain opportunity costs when redesigning office processes for the purpose of achieving greater efficiency because many of the decisions made during this redesign process involve "who does what and when."

In the early seventies, a practice management book written by Bob Levoy depicted the benchmark to be achieved by practicing physicians—*The $100,000 Practice*. I recall a well-known practice management expert stating, "If your practice is generating $100,000 a year, your time is worth $50 an hour. A $50 per hour doctor should not be doing $10 an hour work." On cursory hearing, this statement might "sound correct," but one making it is obviously not taking opportunity costs into account. Adhering rigidly to such advice results in the creation of support staffs (those who do the "less than $50 per hour" work) that are too large, costly, and less efficient than smaller and better-trained staffs.

There is always potential for making a wrong decision when basing an assessment on averages. For example, in today's practices in which DPMs have two or three years of residency training, one who averages $500 an hour might be producing $2,000 during certain hours and nothing at other times. At the times when s/he has no opportunity to produce income, the doctor's opportunity costs are zero. At such times, we do not want that doctor to interrupt an assistant who is already performing productive work in order to ask him, or her, to perform a task (a less than $500 per hour one) which the idled doctor could easily perform him/herself (i.e., remove a dressing, or schedule a return appointment from a computer terminal located in the treatment room). If such a need occurs at a time when the doctor's opportunity costs are zero, it is the doctor who at that moment is the best person to perform that task. While some of these tasks may seem to be relatively "insignificant," failure to consider the doctor's opportunity costs in such "small matters" can result in substantial overall cost increases and practice inefficiencies.

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A "micropractice" consisting of one doctor, one nurse, and optimum use of information technology is an extreme example of the allocation of physician and staff time based primarily on opportunity costs; however, if this practice grows, inefficiencies creep in. Where the teamwork of one doctor and one staff have worked well, growth can create inefficiencies—often to the point that by the time a practice has grown to three doctors, staff size has swelled to twelve, or more.

A doctor who is deciding either to open a private practice or be employed will be giving up an opportunity. The financial measure of this decision is the opportunity foregone, which is generally the difference between the salary offered for employment and the potential compensation and opportunity were s/he to be the owner, or partner, of a private practice. Were the doctor to open a private practice, the opportunity cost of that decision would be the employment salary offered that s/he is foregoing. Similarly, if the doctor chooses employment, the opportunity cost of that decision would be the potential salary and future profit potential of a private practice that s/he is foregoing.

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A major decision being faced by doctors in solo or small group practices today is choosing between remaining independent, forming or joining a supergroup, or being acquired by a venture-backed management company. When making this type of decision, several options are mutually exclusive. A decision to "sell" makes the other choices foregone opportunities. Obviously, other factors such as age, a change in lifestyle, etc., also enter into this type of decision. When opting for one choice over another, one should first make the financial comparison between the alternatives, recognizing that the next-best opportunity foregone will be the true cost of the decision. Even though opportunity costs do not appear on your financial statements, know that they clearly have an impact on your long-term financial success. **PM**

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