

PRACTICE MANAGEMENT

HOW TO MANAGE PROFITS

The key principle to improving profitability is by managing margins up and overheads down.

Managing margins up

Regarding the income statement you will notice that you can improve margins by any of the following or combinations thereof:

- increasing the volumes of sales
- increasing selling prices per unit
- decreasing the cost of the items sold.

A common mistake made by businesses in an attempt to increase profits is that they offer discounts to increase their



sales volumes. However, if volume increases do not make up for these discounts, the profits will decline instead of increase.

Look at the following example:

	Normal pricing structure (R1)	Discounted pricing structure (R0.95)
Gross sales	1 000	950
Less: Cost of sales	(600)	(600)
Gross profit	400	350
Overheads	(250)	(250)
Net profit	150	100

If discounts of 5% were offered to customers and no additional sales were made, the gross sales would reduce to R950, while *all* the other expenses would remain the same, i.e. the cost of sales and overheads. It therefore follows that this R50 reduction in sales amount drops through to the bottom line with R50. The 5% discount in price reduces the net profits by 33.3% ($50/150 \times 100$).

In order to assess what percentage discount is affordable, one needs to calculate the additional sales that need to be achieved before offering discounts. Using the previous example, we need to first calculate by how much the sales need to be increased in order to achieve the same net profit.

The following calculation illustrates how to determine the required increase in sales to compensate for the reduction in profit margin due to discounts:

Profits for the year before tax	100 000
Minus tax payable @ 30%	(30 000)
Profits after tax	70 000
Dividends paid (say)	(20 000)
Secondary tax @12.5% of 20 000	(2 500)
Retained profits for the year	47 500

Sales	R1 086
Cost of sales 63.15% of R1 086	(R686)
Gross profit margin (36.84%)	R400
Overheads	(R250)
Net profit	R150

Managing overheads down

Overheads can consist of fixed expenses or variable types of expenses. The key to controlling overhead costs is to reduce variable expenses (e.g. telephone costs) as much as possible while avoiding a simultaneous increase in fixed costs. Fixed costs are difficult to manage down once they are incurred, as they usually consist of long-term contracts that cannot be reduced or the arrangement changed easily (e.g. salaries, rent, hire purchase instalments).

One of the 'invisible' overhead costs in a business is the depreciation of the fixed assets of the business. For example,

the practice, at its inception, owns R50 000 of medical equipment. This equipment has a useful life expectancy of 5 years, after which it will be worth R10 000 only, resulting in a cost of R40 000 over 5 years, i.e. R8 000 cost per annum. This cost is called 'depreciation', and needs to be accounted for in terms of profitability. For cash flow purposes, the R50 000 was paid on day 1 (cash outflow), and the bank provided the finances on day 1 (cash inflow), with no net cash outflow at the beginning.

Depreciation is a major expense item included in the 'overhead costs' of the practice, but which is often ignored until major replacements in equipment are needed.

Break-even point

Break-even point is the point where the value of the sales achieved equals the combined value of the cost of sales and overheads.

$$[\text{Sales} = \text{cost of sales} + \text{overheads}]$$

It is the point in sales where a practice is neither making a profit nor a loss. Every practitioner/practice manager should know what his/her practice's break-even point is. For any business to stay in business, the least it must do is to cover its costs. There are three types of costs that a business has to cover. These include:

- direct costs (cost of stock)
- overheads (salaries)
- finance cost (interest).

If a business is able to produce a gross profit by selling its products, those profits can be utilised to cover the overhead expenses. Once the overheads are covered, these profits become net profits, as the business is making more money per month than it is paying out.

The following example illustrates the concept of break-even analysis. Assumptions:

- The proportion of drug sales to professional fees is 2:1. This means that for every R2 of drugs dispensed, R1 professional fees are earned.
 - The cost of the drugs sold amounts to 60% of the sales amount.
 - Overhead cost of the practice amounts to R15 000 per month.
- Break-even sales calculation (per month):
- overhead costs to be covered – R15 000
 - gross profit percentage calculation sales (drugs and fees together) – R300
 - cost of drugs (60% of R200 – R120)
 - gross profit – R180
 - gross profit % of sales – 60%.

Two types of calculations can now be done in order to gain insight into the profitability of the practice:



Break-even sales volume calculation

How many units should the business sell to achieve break-even?

This is calculated with the following formula:

Break-even sales volume = (overheads +/- interest)/gross profit per unit

Overheads	R15 000
Expected sales volume	300 units
Selling price	R10
Cost per unit	R4
Break-even sales	R15 000
	= 2 500 units

To cover the R15 000 overheads, the total profit needs to be at least R15 000 and the total sales therefore must equal 2 500 units. The sales needed to break even are thus 2 500 units per month (R15 000/6), after which profits will be made.

Break-even price calculation

The price we should be charging for our products and/or services to achieve break-even:

Break-even price = (overheads +/- interest + cost per unit)/expected sales volume

Overheads	R15 000
Expected sales volume	300 units
Cost per unit	R4
Break-even price	(R15 000 +R4)/300
units	= R54

Excerpted with permission from the Financial Management section of the Distance Learning Practice Management Programme of the Foundation for Professional Development of SAMA. For information on the FPD courses, contact Annaline Maasdorp, tel (012) 481-2034; e-mail: annalinem@samedical.org