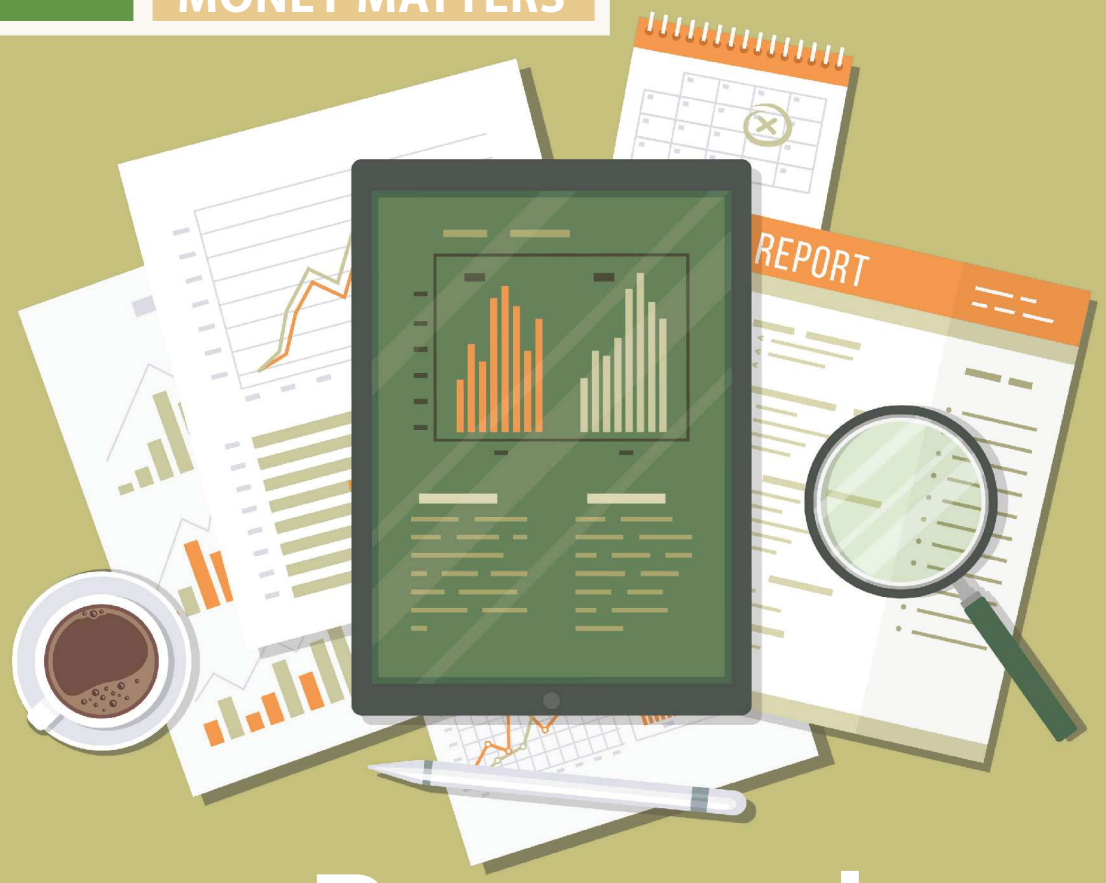

Be a number cruncher

Analyzing income-to-expense ratios will help unlock profits. A detailed chart of accounts and benchmark reports are good starting places.

By Leslie A. Mamalis, MBA, MSIT, CVA

When practice owners and managers want to increase profitability, one of the first things they do is analyze expenses to identify areas where more is being spent than expected. From there, the challenge is to find ways to increase revenue or reduce expenses, or both, without sacrificing quality or service.

Often, the best way to find where profit is leaking out of the practice is by monitoring metrics related to income in specific categories and the direct expenses associated with those categories.

What is important is to interpret the trends and provide context. For example, you would be concerned if spending on diets was high in a particular year and food income had not increased. However, if income from food sales rose by at least as much or more than the costs, you might not have any concern.

To understand whether your profit is increasing or decreasing, use income-to-expense ratios. These ratios are tools that help you evaluate whether your fees are keeping up with expenses, and where profit is lost from missed charges, lack of training or, potentially, the theft of products and supplies. They are particularly helpful for analyzing the cost of goods sold, which are the direct costs related to providing veterinary services and products.

Money In, Money Out

The income-to-expense ratio tells you how many dollars of income you receive from every dollar you spend. For example, a ratio of 5-to-1 (also represented as 5.0) means that $5 in gross fees is generated for every $1 of related expense.

In every business, the income-to-expense ratios must be greater than 1-to-1 or the business is in serious financial jeopardy. A ratio of 1-to-1 indicates that a business makes $1 for every $1 it spends on the physical items consumed while providing the service.

But, of course, more than inventory and supplies are needed to provide veterinary care. You also need doctors, support staff, medical equipment and a hospital, to name just a few. Simply covering direct expenses is insufficient for creating a viable business.

Categorize Products

To perform the analysis, you need matching income and expense categories. Start by creating paired categories for

products consumed or sold. This will help you track margins over time. You can use broad categories, such as dispensed medications, injectable medications and flea/heartworm medications, or your categories can be more specific depending on the level of detail you wish to track.

For further guidance, use a standard industry chart of accounts, such as the AAHA/VSG Chart of Accounts for companion animal hospitals, which is available at http://bit.ly/2wCpSXD.

Save yourself some work and incorporate the same income accounts into your practice management software. When an income account has a matching expense account — for example, anesthesia income and anesthesia expense — if profit starts to fall, evaluating income-to-expense ratios will help you zero in on the problem. In contrast, a catch-all expense category like drugs and supplies is very large, and income and expenses are difficult to assess because consumable supplies in the category, such as syringes, gloves and gauze, do not generate revenue.

Now, if the drugs and supplies expense equaled 22.0 percent of total income in 2017 and increased to 23.6 percent in 2018, you will know that costs increased faster than the income. But you don't know which specific costs increased. Teasing out the problem area or areas will be time-consuming if you don't use more specific income and expense categories. Determining how to improve the drugs and supplies expense is difficult if you don't know what is driving the expense.

What the Numbers Show

Let's look at an example of laboratory income and expenses. (If the data is broken out properly, you can analyze in-house lab income and expense separately from referral lab income and expense.)

The chart above shows the income and expense trends for a four-year period as well as growing profitability. In 2015, the income-to-expense ratio was $4.12 in laboratory revenue generated for each $1 of laboratory expense. The reciprocal tells us that for every $1 in revenue, there was 24.4 cents in expense. In the subsequent years, the lab revenue increased while the expense stayed relatively constant.

Let's look at a similar analysis with food. The chart on Page 28 shows the income generated from the sale of all diet products, the cost of the food and the income-to-expense ratios.

Notice that the food expense was substantially higher in 2018 than in other years. This tells you that you are purchasing more food,

Laboratory	2018	2017	2016	2015
Income	$318,000	$315,000	$290,000	$280,000
Expense	$67,170	$69,000	$66,000	$68,000
Income/Expense ratio	4.75	4.57	4.39	4.12

Dietary	2018	2017	2016	2015
Income	$82,027	$81,951	$87,595	$74,313
Expense	$78,652	$62,517	$62,884	$55,089
Income/Expense ratio	1.04	1.31	1.39	1.35
Expense percentage	95.9%	76.3%	71.8%	74.1%

or paying more for food, than in the past. How does this compare with sales? In 2018, sales were almost the same as the year before. As a result, the income-to-expense ratio decreased significantly.

In 2018, the practice generated only $1.04 for every $1.00 spent on food, which is much less profit than in the past. The change could have many potential causes. A mistake could have been made in allocating the expense, perhaps food purchased at the end of 2018 was not sold until 2019, or maybe more food was used in-house for hospitalized pets and boarders. This metric bears further scrutiny because of the significant change.

Next, break down the 2018 analysis to calculate ratios for each calendar quarter. Was the change gradual or sudden? Dig into the details and isolate the problem.

Consider Benchmarks

You can see the power of creating pairs of income and expense accounts. The caveat is that when it comes to drugs, you must ensure consistency in where things are recorded, both on the income and expense sides. For example, morphine injections could be tracked under controlled drugs, injectables, pain medication or anesthesia. All these are legitimate allocations, but in order to make good management decisions, you should choose one category for tracking purposes.

What are ideal income-to-expense ratios? Both the American Animal Hospital Association and Well-Managed Practice Benchmarks publish benchmark ratios for some services, though neither has an exhaustive list.

When comparing ratios from your practice with any source, make certain you include the same items in both the income and expense categories that were included in the survey. Otherwise, you cannot make meaningful comparisons. Also, recognize that industry benchmarks are simply descriptive statistics about other practices. These benchmarks are not goals but rather a means to understand how your practice compares.

To understand the trends in your practice, benchmark historical performance against current performance. This comparison will provide specific information about your income-to-expense structure and how it is changing, for better or worse, over time.

The purpose of an income-to-expense ratio analysis is to give you targeted information to help you manage your practice. The more paired income and expense categories you track, the faster you can identify areas where costs are rising disproportionately to revenue. ■

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