Summit
VETERINARY ADVISORS

HOW TO ANALYZE YOUR PRACTICE USING FINANCIAL RATIOS
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Financial ratio analysis is a powerful tool in your toolbelt to help you understand your practice's performance and help better manage it. A routine process of regularly examining key ratios and performance indicators can help you make sound decisions and ensure you reach the goals you have for your practice.

First, let's define just what we mean by "financial ratio analysis." You're probably familiar with the term "KPI." Financial ratios are just that, a set of key performance indicators (KPI's) that measure the relationship between two or more components of financial statements and are used most effectively when results over several periods are monitored. This information is beneficial because, when done correctly, it can highlight areas for improvement and assist you in making important financial decisions.

Before sitting down to calculate ratios, verify that the numbers are complete and accurate! If your financial statements are incorrect, financial ratio analysis could not only be worthless, it could lead you to make unwise decisions.

Once you have accurate, reliable financial statements, it is then important to understand where your practice's current financial health is, and what story the numbers are telling. What are some areas that you know need improvement? Financial ratio analysis can include many different areas to measure. Remember, just because you *can* measure something does not necessarily mean you *should* measure it. Knowing the financial areas that make a difference to your specific practice is essential before deciding which ratios will be helpful to measure for your practice.

Here are a few of the most common financial ratios that are important to consider:

Profit margin: You are probably familiar with this ratio, but let's go ahead and break it down. This ratio is calculated as a percentage by dividing net income by total gross revenue. It shows what percentage of sales are left over after all expenses are paid. The higher the percentage, the better. For the veterinary industry, a good range for this would be about 12-15%. A lower profit margin indicates that a practice's expenses are too high for the amount of revenue it brings in. In this situation, management needs to monitor the budget closely and possibly cut some expenses. Lowering expenses is a good thing, but there are only so many cuts you can make. The meat of this ratio comes from the top line, so focusing on improving gross revenues can be a great way to improve this ratio. This can be done by increasing fees, capturing more charges, adding new revenue streams, and bringing on new associates, to name a few.

Income to expense ratio: If your practice utilizes the AAHA chart of accounts and breaks out revenue with matching cost of goods sold accounts, this ratio will be a great one to calculate quickly and easily, especially if your costs of goods sold as a percentage of revenue is higher than desired. By dividing the revenue for a specific category by its matching cost of goods sold, you can see how much revenue you earned for every dollar of expense. You can then monitor that ratio over time to make sure it's moving in the right direction. Take lab for example. If you have $525,000 in total lab revenue and divide that by the direct lab costs of $125,000, you get an income to expense ratio of 4.2. This means for every $1 you spent on lab costs, you earned $4.20 of revenue.

Current ratio: Ever heard the phrase "cash is king"? When we are talking in business terms, it most definitely is. If your practice does not have enough cash to pay all its debts, the doors won't stay open very long. The current ratio measures liquidity, which is the ability to pay short-term (due within one year) obligations. To calculate the current ratio, simply divide total current assets by total current liabilities. While the range varies depending on the type of practice you have, a ratio between 1.5 and 3 is generally considered healthy. A ratio of 1 is a "break-even point," meaning that there are just enough assets to cover the liabilities. Anything below 1 may indicate cash flow problems. On the other hand, a ratio higher than 3 suggests that the company is not utilizing its current assets efficiently. We have seen this to be the case with a lot of practices lately, especially with the recent PPP loan proceeds. We have been blessed as an industry that has actually thrived during the pandemic, so many practices have a material amount of excess cash still sitting in their bank accounts.

Inventory turnover: The word "inventory" has almost become taboo in our industry. It seems like you hear groans just mentioning the word. And that is not good. Inventory represents a significant expense in a veterinary practice, and therefore should be managed very closely and frequently. Are you using cash to generate revenue, or is it sitting on the shelf in inventory? Inventory is not an investment. It does not appreciate in value as it sits on the shelf. Using this ratio can help make managing inventory a little easier since it measures how many times a company has sold and replaced inventory during a period. This calculation is a bit more involved than the others, but still very much worth the time. To get the number of "turns" inventory makes, divide the cost of goods sold by the average inventory. Inventory should turn about 4 to 5 times a year in your practice. Once you have the turns, you can then divide the number of turns by the number of days in that period to see how many days it took to sell the inventory on hand. Higher demand items should turn every 30-45 days, while moderate demand should turn every 60 days. If inventory sits on the shelf too long, take action! Establish better purchasing procedures. Count and track physical inventory as frequently as possible and make sure those counts are reflected accurately in the inventory number on the balance sheet and in cost of goods sold. Shelf life can be one of the top reasons inventory costs might be out of line in your practice. Do the "Red Dot Test." Put a red dot on all your inventory items at the beginning of the month. At the end of the month, find the items that still have dots. Then look at it again at the end of the following months. If you see red dots for several months in a row, those items are costing you money.

These are just a few ratios that are beneficial and worth your time managing. There are many more, but narrow down a handful that are relevant to you and your practice and calculate them regularly to provide insight into how the practice is doing. Financial ratios are not just something for investors, bankers, or the CEOs of Fortune 500 companies to review. It is something YOU should be doing with your practice! If you don't have the time, skill, or interest, find someone who does and have them do it for you!

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