

ASSESSING THE FINANCIAL STATUS OF YOUR PRACTICE

Possibly the most important reason that motivates doctors to go into private practice is the lure of making considerable amounts of money. There was a time when private practice almost guaranteed large profits, but the situation is rapidly changing and some doctors have found that they could be better off either working for the government or for one of the larger corporations.

At present, doctors with five or more years of experience can earn up to R180 000,00 per annum in the public service and often considerably more in the large corporations. Recently a young colleague in the Northern Transvaal, with a turnover in excess of R1-million per annum, complained to me that even with this large annual turnover his monthly take home salary amounted to just less than R13 000,00. The reason was that even though he was a skilled family practitioner with a busy practice, he had no financial training, and very limited financial skills, resulting in the poor financial management of his practice. His problem was that most of the turnover was being spent on unnecessary overheads.

The impact of poor financial management can be quite disastrous for the doctor. It can occupy so much of the doctor's time that it detracts from the quality of health care that the practitioner can deliver, and therefore has the potential to reduce job satisfaction and even disrupt family life. Often the reason for this is the debt that has been allowed to get out of control.

Debt incurs interest that leads to an intolerable financial burden. The only way to finance this interest is to work longer hours. Eventually, these sustained longer working hours take their toll. Clinical judgement is affected and quality family time is usually the first thing to be compromised as the doctor spends less time at home and more in the office.

Even physical and mental well-being can be affected as the doctor spends longer hours working to pay off the interest on the debt. All of this is an expensive price to pay for inadequate financial management, particularly since the situation can be avoided by applying some of the basic principles of finance.

The role of the financial manager is to source (find) money and to ensure that it is used effectively. Decisions about how to put money to the best use require particular skills and understanding about financial matters. The financial manager is responsible for ensuring that the practice remains optimally profitable and solvent. A decision should be taken within every practice as to whom the financial manager is going to be. If the doctor feels inadequate to optimally fulfill this role, this function should be outsourced.

Of course, practice decisions cannot be based only upon monetary considerations. Other elements to bear in mind include the ethics of clinical practice as well as certain other factors such as the present political dispensation, ruling economic conditions, the social disposition of the patients, available technology and the trends within the health industry. As these so called "external environmental" influences change they will have an impact upon the financial decisions that are made. The financial manager, therefore, not only needs to have a solid foundation in finance but must also take into account the ever changing external environmental influences.

It is important to emphasise the problem that many doctors have in differentiating between their own private affairs (their household) and those of the practice (their business venture). Even though the doctor may be the sole proprietor or owner of the practice, for good business and financial reasons it is important to accept the business venture or practice as a unique entity, quite

separate from the household. The reason for this will become obvious as you read about the methods that can be used and the need for analysing your practice.

I Financial Decision Making

Sources of Money

Starting a business venture requires capital (money). There are essentially two sources of money: the long-term capital markets and the short-term money markets. Usually, only large businesses source from the capital markets. Money from the capital market, for example, can be in the form of equity (shares or debentures), while short-term money is, for example, overdrafts and credit.

The basic rule is that long-term debt should be used to finance long-term assets while short-term debt should be used to finance short-term assets. One of the reasons for this is that long-term debt will usually cost more.

Another role for the financial manager is to ensure that all the "money" or "assets" within the venture are being optimally utilised. Money can be put to work for you, but you need to know how to make it do this. Sourced money is usually invested in the business venture or practice. The venture must generate money that could either be re-invested in the practice or in the capital or money markets. See Figure 1.

From Figure 1 you will note that there are at least four points at which important financial decisions need to be taken. A financial decision is based upon the amount of risk associated with it and the anticipated return it is likely to generate.

A wise decision minimises risk while optimising return. Consider the following decision that has to be made. A lung function machine can be bought for R6 000, financed at 28% over the expected life span of the machine — five years. The potential income is R75 for every test done. Two costs have to be considered:

1. The fixed costs
2. The variable costs

This is schematically represented in Figure 2.

The fixed cost is the monthly repayment for the machine. The variable cost is the cost of getting someone to do the test. Assuming that the doctor has to do each test personally at a rate of R60,00 per 15 minutes (a consultation fee), then every 15 minutes spent on doing a lung function test is the variable cost. It increases as the number of lung function tests done increases.

The profit, therefore, of doing a lung function test is R15 (R75 - R60 = R15). But the cost of having the machine is R172,84 per month. Therefore to "break even", $R172 \div 15 = 11,46$ or twelve tests must be done monthly.

Is it a good decision to buy the machine? The risk is that twelve lung functions need to be done a month for five years to "break even" otherwise the machine will be costing you money and therefore will be a factor contributing to your reduced monthly take home salary.

In a similar way consider how an expensive car would be affecting your monthly salary.

II Assessing the Business

In most businesses you reach a stage at which you want to know how well you are doing and how you compare with colleagues. Besides making financial decisions, the financial manager also needs to know how "well" the business is doing. He/she must be able to analyse each component of the business to establish where the problem is, if in fact there is a problem. One way of doing this is by using a structured Du Pont's ratio analysis.

The analysis allows you to compare yourself with either your previous year's performance or with the performance of your colleagues. There are three important components of the business to consider.

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1. The profit (the actual amount of money you made).
2. The capital structure (how much money you use to make this profit).
3. The business activity (how efficiently you use the assets within a business).

1. Profit

The net profit of the business is equivalent to the salary that the doctor is able to draw at the end of each month. Net profit is calculated by subtracting the expenses from the turnover. Calculating the net profit margin by dividing the net profit by the turnover can be used to determine how efficiently the net profit is being generated. See Figure 3.

2. The Capital Structure

Setting up a business requires money. The possible sources of money from either the capital or money markets have already been mentioned. Total assets divided by the ordinary equity indicates the financial leverage multiplier (FLM). The FLM is the value of the assets that resulted from the money used in the business generally. The greater the leverage the more secure the business is.

3. The Business Activity

This provides an indication of how efficiently the assets of the business are being used. Turnover divided by total assets (fixed, current and other) provides the total assets turnover. If all the assets are being utilised efficiently, then the turnover should increase. But, it should be obvious that where an excessive amount of money has been used to purchase assets, it will decrease this ratio. An example would be the purchase of an expensive motor car in a practice which in itself is unable to generate turnover.

4. The Overall Performance of the Practice (ROE)

Multiplying the return on assets (ROA) by the financial leverage multiplier is an indication of the ROE or return on investment. Return on equity or return on investment is equal to earnings divided by the money employed (equity).

$$ROE = \frac{\text{Earnings}}{\text{Total Assets}} \times \frac{\text{Total Assets}}{\text{Equity}}$$

therefore $ROE = \frac{\text{Earnings}}{\text{Equity}}$

5. Return on Assets

The return on assets (ROA) is used to indicate the efficiencies of income production, (i.e. profit) and the activity of the business. Dividing the net profit margin by the total asset turnover provides the ROA.

How close is the practice to bankruptcy?

The Financial Distress Model

Edward Altman developed a mathematical model to predict the potential failure or success of a business. A similar model was developed by De la Ray at the Bureau of Financial Analysis in Pretoria. This model achieved a 96% success rate in classifying the ventures in the samples as either being financially failed or financially sound.

Zero is used as the boundary between financially sound or financially failed ventures. Using this model, the further a venture moves from zero, the more likely it is to be financially sound or in danger of failing. A positive value indicates a healthy financial position, while a negative value predicts failure.

Perhaps you would like to apply this formula to your own practice: $k = -0.01662a + 0.0111b + 0.0529c + 0.086d + 0.0174e + 0.0107f - 0.068811$

a = Total outside financing divided by total assets multiplied by 100%.

b = Profit before interest and tax divided by average total assets multiplied by 100%.

c = Total current assets plus listed investments divided by total current liabilities.

d = Profit after tax divided by average total assets at book value multiplied by 100%.

e = Cash flow profit after tax divided by average total assets multiplied by 100%.

f = Total stocks divided by inflation-adjusted total assets multiplied by 100%.

Figure 1. Financial decision making

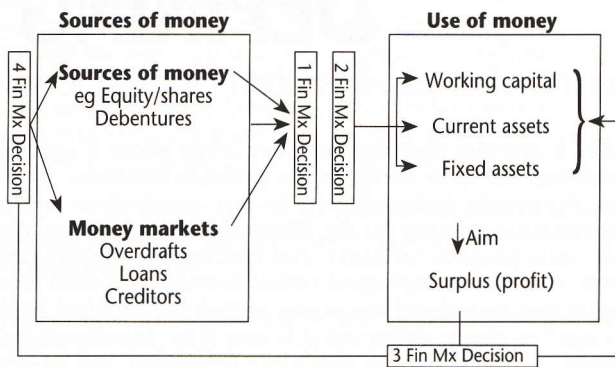


Figure 2. Fixed and variable costs of doing lung functions

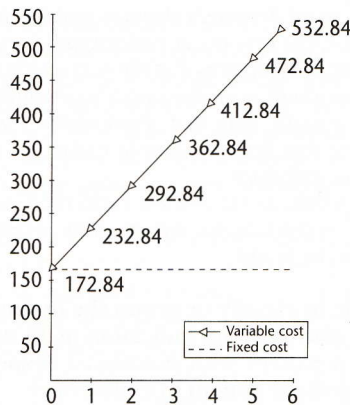
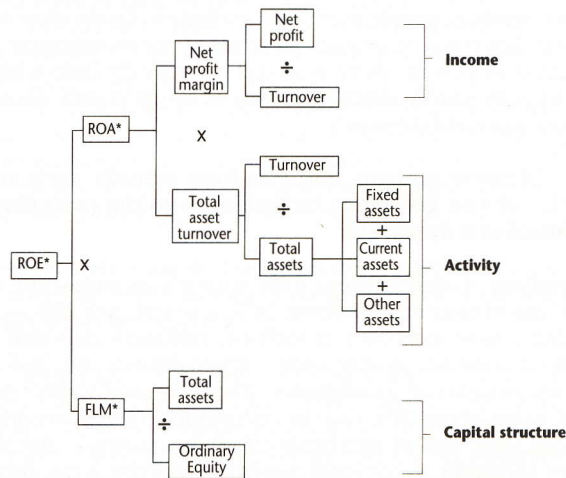


Figure 3. Modified Du Pont Analysis



*ROE = Return on investment *ROA = Return on assets
 *FLM = Financial leverage multiplier

In conclusion, good financial management requires adequate training, an interest in the subject and insight gained from experience in the field.

Financial management is a specialist function. Although doctors need to understand the basics of financial management, it is usually very difficult for them to be efficient financial managers themselves. I am often asked by colleagues how important it is to obtain the services of a good financial manager. The answer is obvious. If you are financially well off and are successfully improving your financial ratios each year, you possibly do not need a financial manager. However, if you are feeling the pinch, are having to work longer hours, have taken a reduction in profits and are financially worse off today than you were two years ago, my suggestion is that you get professional financial management advice. ●