Profit margins

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Abstract
The veterinary industry has perpetually produced excellent practitioners who have often ended up in business management positions through natural succession. These owners are in highly influential leadership positions through necessity, not passion or skill, which ends up with important factors of practice being an afterthought of practicing medicine. Profit margins within the veterinary practice must be thoroughly understood in order for practice administrators to effectively implement pricing structures and help associates and staff members understand where pricing structures come from to communicate effectively with clients. Understanding terminology and calculations required to audit one's numbers can help restructure focus and pricing. Understanding profit margins also helps understand the effect of inventory shrinkage most commonly due to obsolescence among other sources. Having the ability to calculate these numbers for one's practice gives the ability to make systematic changes to improve one's practice.

Key words: profit margin, COGS, overhead, gross profit, markup, overhead, shrinkage, business finance

Business finance 101

Markup and margin
Markup is defined as the difference between the unit cost and unit selling price. Markup is a percentage. For example, a product that costs $150 with a 35% markup would have a sale price of $202.50. This sale price is 135% of the unit cost. Margin is defined as the difference between the selling price and the profit. Margin is a percentage. For example, a product that costs $150 and sells for $202.50 has a gross profit of $52.50 and a 25.9% gross margin. Markup and margin are not the same numbers, and markup on a product should not be directly translated to margin or profit.

Expense categories
There are multiple strategies of coming up with numbers, percentages and categories to work within when it comes to financial management of veterinary practice. Several universal terms that must be understood include gross income, overhead and operating expenses, gross profit, net profit and cost of goods sold (COGS). The two major wage expenses are broken down into DVM and non-DVM staff. Gross revenue is defined as all of the revenue brought into the practice. This is often referred to as the "top-line" revenue. Overhead and operating expenses are costs of operating the company that cannot be directly linked to revenue generation. Examples include rent, utilities, office supplies, professional services, cell phones, office supplies, etc. Gross profit is the profit remaining after the direct cost of selling the product or service is deducted. Net profit is the money remaining once all operating expenses associated with sales are deducted from gross profit. Cost of goods sold are the costs directly associated with creating revenue. Examples of cost of goods sold include medical supplies, laboratory tests, prescription foods and cremation costs. Gross profit is the profit calculated after deduction of COGS from gross revenue. Net profit is the profit calculated after deduction of all other expenses. Net profit can be retained by the practice as savings, distributed to the owner(s), reinvested into the practice or distributed to the employees of the practice as bonus.

Industry benchmarks
Benchmarks for the allocation of gross income are different across industries. For most veterinary practices, I find a simple goal to start at is to allocate 20% of gross income to each category above. One can adjust these numbers based on their sector of industry, but calculating these numbers allows the practitioner a starting point to make adjustments. This means that for a practice with a gross income of $1,000,000 per year, a starting benchmark should have $200,000 going toward overhead and operating expenses, $200,000 toward DVM payroll expenses, $200,000 toward non-DVM payroll expenses, $200,000 to COGS and $200,000 in net profit.

Gross income allocation from the sale of a single product
A quick overview of the categories above allows the practitioner to prospectively calculate the net profit for each product and service conducted within one's company. To calculate this, one must take the cost of the product (A) and subtract it from the selling price of the product (B) in order to calculate the gross profit of the sale (C). Gross profit = B-A. Then, the gross profit can be split into 5 categories allocating 20% to each. For the purposes of this information, COGS is maintained as an allocation category of its own after calculating gross profit for prospective demonstration. When calculating net profit retrospectively, COGS will be deducted only once.

For these numbers to work, a markup of 180% on all products and services should be standard, however, this is not reasonable across all items so adjustments must be made to achieve the average. For example, if a product costs the clinic $100 and the sale price to a client is $150, this product has a 150% or 1.5 times markup. After deducting the cost of the item from the sale price, we are left with a gross profit of $50. The gross profit is then allocated into each of the 5 categories equally in $10 increments. This means the net profit of this particular item is $10. The sale price is $150. To calculate the net profit margin, one must divide the net profit by the sale price (revenue) of the item. In this case $10/$150 = 0.066 or 6.6%. One can use these examples to audit every single product and service to determine the high and low margin items within a company.

The cost of missed charges

Shrinkage
Missed charges for goods are one of several sources of inventory shrinkage in veterinary medicine. Shrinkage is defined as the negative difference between what is actually present in stock and what is theoretically available on the inventory list.

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Sources of shrinkage for a veterinary practice predominantly include theft, expiration, obsolescence and damage. All sources of shrinkage impact the bottom line, but missed charges fall under the category of obsolescence.

Example of a missed charge

The true impact of a missed charge can only be calculated by knowing the net profit or profit margin on a product. For example, if the unit cost of an item is $13 and the markup is 60% the unit sale price is $20.80. The gross profit of this transaction is $7.80. If the clinic is operating with a goal of a 20% net profit margin, then $1.56 of the gross profit will be allocated for net profit, the rest would be spent to pay overhead, COGS and staff wages. If this product was not charged for, the practice would be in the negative by $19.24. This is because the practice is still responsible for paying all other categories besides profit. In order to recover from this, the practice will need to sell over 12 units to break even on the single product missed. This is because the loss of $19.24 divides into the net profit of $1.56 on the item 12.3 times. Following this example, one can understand that lower margin items are much more difficult to recover from and are much less financially forgiving.

Conclusion

In order to discuss these numbers and feel confident in communicating with clients, we must fully understand the cost of doing business. While the numbers we work with are large being a medical profession, the costs are also large and understanding this will give you confidence to hold belief in the appropriate pricing of products. As price transparency increases with the use of the internet, clients will have more access to information and will require more communication in explaining markup and fees. Practices should audit their systems to rank high and low margin items and focus their efforts on diversifying and expanding their capabilities with high margin offerings.

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