Making rational decisions about new services

D. Lewis, MBA
Independent Consultant Long Lake, MN 55356

Abstract
This presentation offers a methodology and tools to evaluate the profitability and potential financial impact of possible new products and services to your practice. We discuss how to set up your current financial statements to facilitate understanding the impact and three important criteria when considering possible new services. You will be exposed to developing management financials and profitability of your current and potential revenue streams as well as developing a value proposition with the input of your various constituencies, your own practical experience, and any research you might have. Additionally, you will learn about the use of partial budgets to evaluate the marginal benefit of potential new services, to analyze sensitivities and set reasonable expectations for new products or services, to integrate and track progress into your planning.

Key words: management financials, revenue streams, value proposition, affinity diagramming, partial budget, new services, breakeven

Introduction
Often, when we are exposed to new ideas, technologies, or products, we can become enamored with the thought that it was "just what we were looking for" or something "new and different" that just might be a big benefit to our practice. Without a disciplined way to evaluate these products or services, we can become what I like to call "a crow." As you all know, being veterinarians, crows are famous for picking up almost any shiny object that they see and taking the object back to their nests – with no real purpose in mind and the object being of no long term benefit to them. We can avoid this tendency by applying a discipline that at a minimum utilizes three criteria.

Three important criteria to consider
First, and perhaps most obvious, is do your clients really want and need it? Is it a basic level need that they acknowledge or is it something more discretionary? If it is the latter, do they understand what benefit it will have for them and do they perceive you and your practice as being the best alternative for delivering this service? Since your clients have a finite budget, do they see an expenditure on this product or service a better allocation of resources than another investment?

You may not have answers to all these questions, and another possible product or service offering may present itself in the near future that distracts you from getting these answers. Furthermore, you may not be the right person to try to answer all of them. What about the insight other members of your staff bring to the party? What about new grads? What about the receptionist who hears from your clients when you are not present? Heck, what about your clients themselves? Shortly, we will see that there is a way to get inputs from all these constituencies down on paper and maintain it as a living document for your reference as you plan your business decisions going forward.

Second, if you have landed on a new product or service you think makes sense, you need to understand if you can offer it profitably. Can you offer it as a "stand alone" service or is it best offered (and only profitable) if offered in combination with another product or service? Finally, you need a thorough understanding of what it will take in terms of investment of dollars, time and effort to establish realistic expectations for return on investment and expectations of when you should be able to see this return. Way too many good ideas suffer from lack of attention when they don't produce immediate results – certainly unrealistic.

The third criterion is to understand how offering this new service will impact your overall practice – your reputation for quality medicine, as a defense against competitive inroads, and ultimately in improving the profitability and value of your practice.

The tools offered in this presentation will allow you to follow a planning process briefly outlined in the diagram below

So, let's start defining each of these steps and how to use the simple analytical tools of management financials and affinity diagramming.

Management financials and analysis of financial performance
In order to analyze the financial performance of your practice, you must get your operating statement, your profit and loss (P&L), into a form that allows you to see the trends of your sales, profits and margins over time, and the source of your sales growth or decline, i.e. revenue streams. Ultimately, you need to see the cash flow generated by your business or at least a good proxy for cash flow in the form of earnings before interest, taxes, depreciation and amortization (EBITDA). While your financial software undoubtedly captures a lot of the information necessary to accomplish this analysis, it doesn't usually display it in a form that facilitates seeing the results. Additionally, it is quite possible that your software did not capture the data necessary to analyze the revenue streams unless you input your data with codes that separates the sources of revenue. Let's talk about a reasonable format for building "management financials" and what to look for in the results in terms of the historical trends, the margins, segments of your practice and where you might want to focus to improve profitability.

I recommend developing a simplified P&L which groups expenses into categories so that you have the ability to see "the forest for the trees." (Figure 2) This P&L will not replace the statements generated by your accounting software, and your accountant will still need that data in the format that the software generates to do your taxes. In developing this format, we will also make some "assumptions" and in some cases ignore specific accounting rules since this view is only for our benefit and not for financial reporting. Our suggested format will work to help you understand what is happening in your practice regardless of the type of legal entity of your business (LLC, S-Corp, C-Corp, sole proprietorship, partnership, etc.).

Figure 1:

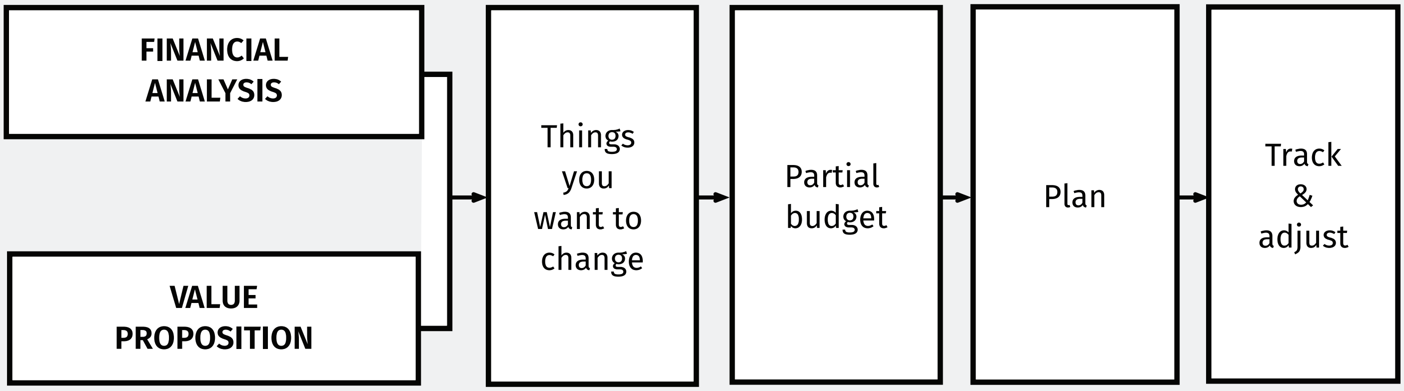


Figure 2:

Revenues

Cost of goods sold (COGS)

Gross profit or margin

Grouping expenses

–10-15 categories

– Fixed versus variable
(more later on this...)

Compensation

– Owner(s) vs. employees

– Legal entity structure

Depreciation and amortization

Cash flow

Profit & loss statement (P & L)

Revenues →	Year
Gross revenue	
Cost of goods sold (COGS)	
Gross profit (margin)	
Expenses	
Payroll / benefits	
Owners	
Employees	
Rent	
Repairs & maintenance	
Supplies, uniforms, etc.	
Professional development / reference	
Travel & entertainment	
Advertising & promotion	
Contributions	
G & A / professional fees	
Interest	
Taxes (real estate)	
Depreciation	
Profit before tax (PBT)	
Cash flow	

Here is a sample format which we have used to analyze many veterinary practices over the last 5 to 7 years:

Revenues may be recorded as "gross revenue" (if you use an accrual accounting convention) or "net revenue." This data usually is the same as your sales or is often called net income in software such a Quickbooks.

"Cost of goods" is a concept most easily understood and applied to manufacturing-based businesses. We will use it to capture a lot of different costs varying from the cost of the drugs you buy to resell to the cost of maintaining your trucks to make farm calls (obviously, this is an example of departure from accounting rules).

Next, we will group our expenses into 10-15 categories such as those suggested above. You can vary from these categories, but don't create too many categories or you will defeat the purpose. Most importantly, keep track of which expenses you collapse into which categories and be consistent for each time period you analyze. Finally, I would suggest not merging fixed and variable expenses, but would recommend keeping a break out of salary and benefits by employee group (owners, associates and office staff) as discrete categories, and keeping depreciation and amortization (D&A) as a separate category. D&A are non-cash expenses and will be added back to the bottom line to get to EBITDA, which is your proxy for cash flow.

Showing your business performance in this format for 3 years of history will give you a good basis for seeing the trends in your practice and will allow you to "benchmark" against yourself (in the veterinary industry regional and reporting differences as well as varying composition of practices makes true benchmarking very difficult and often misleading).

Analyzing segments of your business

Using the format you created above, break each reporting period into the revenue components you want to analyze. There is no singularly correct way to do this, but suggestions that I have would be as follows:

- If you have a mixed animal practice, first separate your revenues into small animal (SA) vs large animal (LA). The margin structures of these two types of practices are very different.
- Create a category that represents the "core" of what you do in each area. Such a category might be called "professional services" or something similar. This category will represent those things you really cannot separate from being in practice. As an example, in the dairy world, this might capture herd checks and general sick cow work. It usually will be the biggest revenue stream in your practice.
- Separate drug sales as a revenue stream. This portion of your practice has a very different margin structure and growth in this segment has a different effect on your profitability.
- Create a category for "farm call revenue." We want to determine whether the charges we have for farm calls cover (or don't) the cost of our transportation (truck including gas, insurance, payments, repairs) and maybe even something to compensate the veterinarian for his/her windshield time.
- Other categories might separate revenues by species, by type of delivery method such as haul-in facilities, lab charges or new services.

There is no one way to do this exercise. It really depends on the composition of your practice and what you want to look at. A general guideline would be to separate the revenue streams into things that are "decisionable" (i.e. could choose to do or not or could be managed differently).

Display the revenues as columns adding to the total revenue for a given year and associate expenses with the relevant revenue stream using a marginal expense and contribution methodology. A way to think about this is "would the expense go away if I were to stop offering this service?" Do not just allocate a portion of a fixed expense to the revenue stream based on the percentage of total sales it represents. As an example, clearly, if you stopped offering embryo transfer as a service, you could not eliminate some percentage of your lease payments. What you are trying to determine is whether it in itself is making or losing money for you and how much additional cash flow and profitability any of these revenue streams adds to your total practice.

At this point, you have a good basis and format for understanding the financial performance of various services you offer and how new products or services you are considering would impact your practice. This is the first step in making rational decisions about adding new services and/or reallocating current resources to make that possible.

Do my clients want or need a particular new service?

At this point, we have a good idea based on historical performance how the overall practice is doing and which discrete products or services contribute to that performance. We know which ones are improving our margins (can we do more of these?) and which ones are pulling down the average (can we improve their profitability or eliminate them?).

We will turn our attention now to new products or services that might be appropriate to consider. First, and by far the most important question, is do my clients want and need a particular service and do they see me as the provider to offer it? Using a technique for managing group input and consensus called affinity diagramming, we can create a "value proposition" on paper that allows us to consider various alternatives and organize our thinking. First, what is a value proposition? Wikipedia defines a value proposition as "a promise of value to be delivered and a belief from the customer that value will be experienced." Notice that the definition does not use the word "price", so let's not fall prey to the idea that our value proposition is "to be the cheapest in town." Finally, our value proposition will be different depending on the group of clients we are serving. Logically, beef cattle clients are not going to find value in the same group of products and services as dairy clients and large animal clients certainly want different products and services from small animal owners.

Affinity diagramming

Getting our thoughts down on paper is a 4-step process. Step 1 is to get as many inputs into the process as possible, and a way to do this is to ask all of your professionals, office staff and even clients to write on a Post-It note as many things that they look for your practice to provide as they can think of (one per Post-It note). This is not the time to filter out thoughts, but be careful to express the want or need from the client's point of view. Clients don't want the newest shiny machine (that's being a crow), they want something that the machine will do to benefit them.

Figure 3:

Then, get all these entries up on a flip chart (Figure 3) or white board or wall where everyone can see them and add more if they wish. Let it stay there for a while. Invite your clients into this exercise – it will pay dividends later. Don't worry about organization at this point.

The second step involves organizing all of these inputs into categories and creating headlines for them. There is no single right way to do this; it depends on how you and your staff think about your practice. For instance, a bunch of the inputs might fit under a title of regulatory services, or under sick cow treatment, etc. Keep at it until you can get everything under 3 or 4 headings. (Figure 4) At this point, you can also combine the thoughts on various Post-It notes into an expression of a need that best describes how your client thinks about it. Incorporate any research you might have at your disposal and be sure to give significant weight to your client's inputs.

In the third step, separate all of your products and services into 3 levels of importance. The first level is the "Base Level" or those services you must provide to meet minimal expectations of a practice of your type in your area. Next is "Level One" or those products and services that can distinguish your practice from others with whom you compete. Finally, the last level is "Level Two" which represents those offerings that would be home runs and in fact you may not even know how to deliver today. The result of reorganizing your thoughts in this way is that you have created a matrix as shown below. (Figure 5)

Finally, the fourth step is to assess how well you deliver each of these offerings today. Green is great and just fine. Yellow represents improvement needed and red suggests you don't deliver it at all today or don't know how.

The resulting output of all your work might look something like this (Figure 6) with more content than shown here.

You now have a representation of what you'd like "to look like" in total to your clients and what needs to be improved. Importantly, it has been developed with the input of your staff and hopefully even your clients so there should be buy-in to the end goal. You have captured this on a few sheets of paper and can use it throughout the year as a reference point and can easily update it as you learn of new technologies, needs and capabilities.

Understanding the impact on your practice

From our value proposition work, we can choose one or more services that we think will be most valuable to our clients (remember that we have their input) and that will distinguish us as a practice – "our brand" if you will. It is important to now map out what will be involved in bringing this service to market and what impact it will have on our financial performance. For that work, we can use the tool known as "partial budgeting." As we develop our partial budget, we will establish all the benefits and costs we expect to see from this new service, a

Figure 4:

timeline for implementation, a break-even point when offering this service ceases to be a cost and begins to add to profitability, and metrics we can use to track our progress as we go forward.

To begin, we must recognize that any new product or service has the potential to increase revenues in one way and possibly decrease revenues in another and the same is true for costs. In fact, if we look back at the P&L we described earlier, there may even be existing revenue streams that are below average in profitability and we would like to offset or replace. For simplicity, let's create a matrix (Figure 7) to capture these increases and decreases. While we are capturing these revenues and expenses, we need to separate fixed expenses – those that do not vary with unit volume – from variable expenses that as the name suggests do. A fixed expense might be a machine you needed to buy, but a variable expense might be the syringes, chemicals, drugs, etc. that you use in each application.

Once we have identified our assumptions as described, we can calculate a break-even point as follows:

Break-even Point (N) = TFC / (P-VC)

Key: N= number of units; TFC=total fixed costs;
P=price per unit; VC= variable cost per unit

Break-even analysis example

As an example, let's look at a possible embryo transfer situation. From the dairy value proposition, a practice believes that it is important to add embryo transfer to the services they provide so they do their homework and make the following assumptions. On the revenue side, they believe the appropriate price to charge per flush is $250, and that on average, a flush will yield 4 ova. They will transfer half of the ova right away at a price of $60 each, and half will need to be frozen for use later at a price of $50 each. So if we look at increases in revenue on the basis of 100 flushes (just easier than on a per unit basis), we have revenue of $25,000 for flushing + $24,000 for all transfers (400 transfers) + $10,000 for freezing (200 ova) which equals $59,000. For the sake of the exercise, we will assume that this activity will cause us to forego $5,000 in service call revenue (a decrease) and therefore our net increase in revenue is $54,000 for 100 flushes.

On the cost side, we assumed training to get started at $3,500 and fixed equipment cost including freezer of $8,500 for a total fixed cost of $12,000. Variable costs again for 100 flushes totaled $6,500 and our professional in this practice was paid 50% of the $59,000 of revenue associated with this service, or $29,500, bringing total variable costs to $36,000.

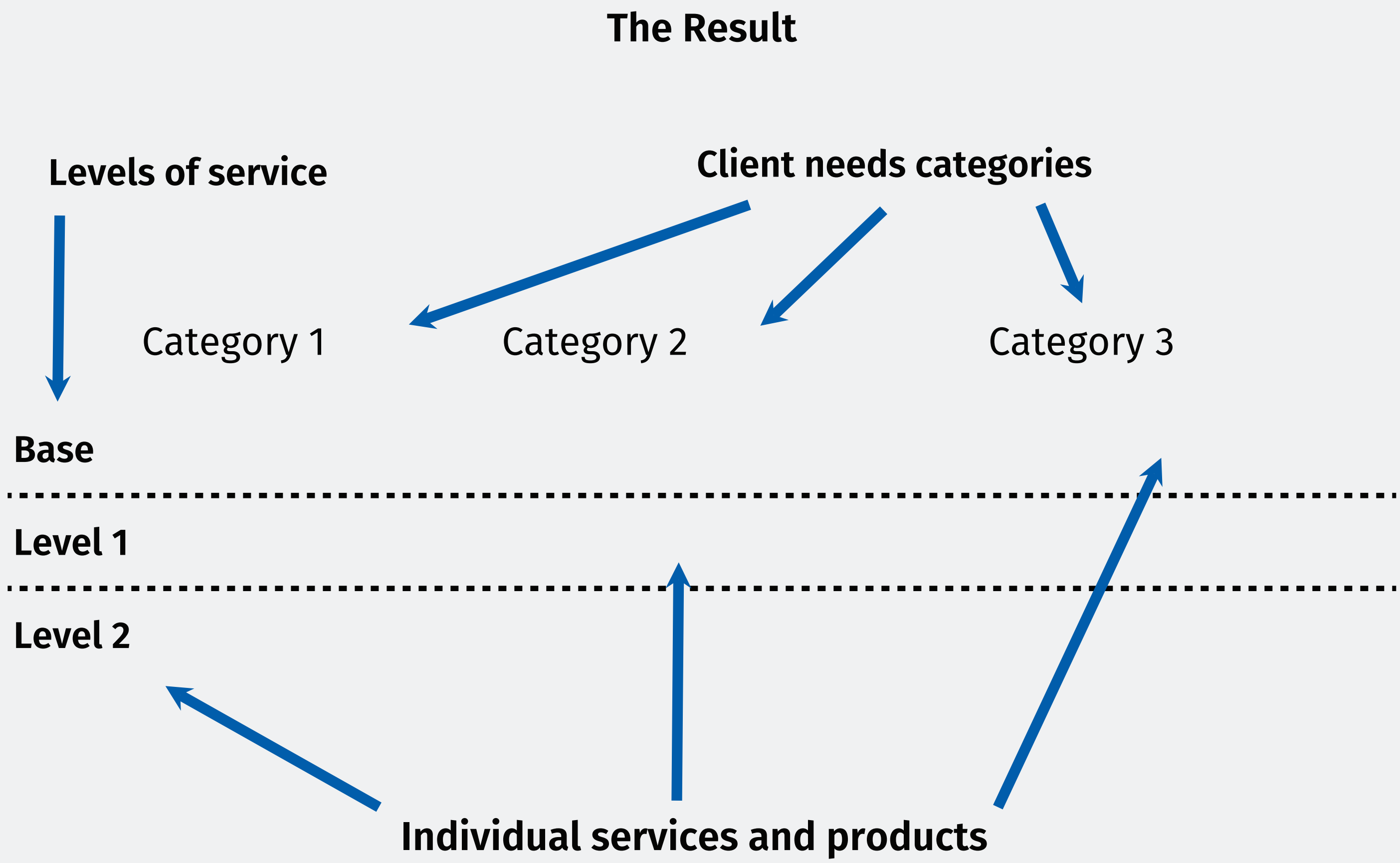
Using our break-even equation, N= $12,000/(540-360) = 67 procedures. When will we have accomplished 67 procedures? That question takes us to developing a timeline.

Creating a timeline

All too often, we oversimplify things in our minds by forgetting a lot to the details that are necessary to accomplish a complex task. As we put them on paper, we can often catch our mistakes. In our ET case, we said the following:

- **Week 1 –** Attend a seminar or training session
- **Weeks 2 to 5 –** Order and receive all supplies and equipment necessary
- **Weeks 5 to 6 –** Begin developing skills by collecting flush fluid from excised reproductive tracts, searching fluid, using embryo freezer and transfer equipment.

Figure 5:



- **Weeks 7 to 8 –** Practice collecting fluid, ova and single embryos from live cows and searching, freezing and transferring.
- **Weeks 9 to 12 –** Practice scheduling, collecting embryos from super-stimulated cows, searching, freezing and transferring to recipients.
- **Week 13 –** Begin offering ET commercially and tracking biometrics.
- **Week 46 –** Assuming we are doing two flushes per week, we have reached our 67 procedures and should be breaking even.

When we include the various steps outlined above to gain the expertise to offer the service and time to practice so that you are a pro from the start, it often surprises people that it takes this long. Given this information, we also have metrics we can track including biometrics like percent of fluid recovered per flush, fertilized and unfertilized embryos per flush, and pregnancies per flush to see if we are on track with our initial assumptions. If not, we can adjust. We also can manage our expectations concerning financial results. If we actually started our effort on January 1, we could expect to have broken even by mid-November. However, it is more likely that we started somewhere during the course of the year and will still be in "a loss position" by year end, but it should not come as a surprise to us and we will know how much additional profit we can plan for year two.

Finally, by analyzing the impact in years one and two, we can tell how this service will impact the overall performance of our practice. Is it improving our margins and cash flow? By how much? At the very start, we could have used the same partial budget methodology to analyze 2 or 3 possible new service additions to determine which ones had the greatest positive impact on our practice.

Assuming that we have the flexibility to choose among the new services and when we start offering them, we can predetermine the impact on our practice over a 2 or 3-year period. Also, by running these scenarios with alternative assumptions – some more conservative and some more aggressive – we can get an upfront indication of the sensitivity to the ultimate outcome of different variables including price, procedures per week, and biological success measures.

Closing

In closing, while using the management financial structure, the value proposition exercise and the partial budgeting tool won't guarantee success, it provides a disciplined framework to decide which services to add, what your expectations should be, how to tell if you're on track in the middle of the fray, and ultimately, what impact you should experience on margins and cash flow in your practice. And, it is primarily cash flow that creates practice value!

Figure 6:

Your dairy value proposition . . .

Client needs categories

Level of service	Technical services	Analysis / business planning	Compliance / regulatory
Base	Identifies open cows in a timely manner with rectal palpation or ultrasound. Is current on latest treatments for common metabolic diseases. Provides 24/7 availability of critical services in case of emergencies.	Regularly compiles and compares monthly herd records to existing and future benchmarks. Reviews vaccination protocols in light of disease burden and newly available products.	Performs required testing and vaccinations to ensure compliance with federal and state regulations when issuing health papers (CVI). Has developed farm-specific plans in the event of a FAD.
Level 1	Strategically uses embryo transfer to enhance genetic base of the herd. Determines fetal gender with ultrasound to augment reproductive management decision-making.	Understands the process and procedures for partial budgeting and can incorporate this into healthcare decision-making. Actively participates in management team meetings with other stakeholders, e.g. nutritionists.	Designs and monitors outcomes of treatment protocol to assess efficacy and ensure regulatory compliance. Provides training for employees on health management and antibiotic use.
Level 2	Facilitates in-vitro fertilization for capture of unique genetic lines. Has haul-in facilities as an option for delivering health care to individual and small groups of cattle.	Incorporates forecasting to better characterize risk of financial decisions outside animal healthcare. Guides management decisions for forward contracting of milk and key dairy inputs.	Identifies and addresses animal welfare concerns through regular audits. Is fluent in the primary language my employees speak, e.g., Spanish.

Figure 7:

PARTIAL BUDGET:			
INCREASED REVENUE:		DECREASED REVENUE	
Item:	Amount:	Item:	Amount:
REVENUES			
Total:		Total:	
DECREASED EXPENSES:		INCREASED EXPENSES:	
Item:	Amount:	Item:	Amount:
EXPENSES			
Total:		Total:	
(Increased revenue + decreased expenses) – (Decreased revenue + increased expenses)		NET CHANGE:	