# Look Deeper into the Financial Impact of a Discounted Fee Schedule

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By Richard A. Green, DDS, MBA

Lynn Carlisle recently wrote an article for his Internet newsletter, *In the Spirit of Caring* (www.spiritofcaring.com), concerning the *Financial Effect of Delta Dental's 15% Cut* on the State of Washington Dentist's Fee Schedule. I agree with much of his article concerning the impact of the Delta Dental 15% Cut. I dislike the use of the Kodak Study as a comparative or reference for Dentistry. I am writing to continue the conversation in hopes of promoting a greater understanding around the reasons why the Kodak Study is not a good reference point!

I know the Kodak Study has been used for many years, by leaders in dentistry, to help other dentists better understand the impact of a discount on the cash flow of a practice. The Kodak Study can be used as an "engager" concerning our thinking about the consequences of raising and lowering our fees. My concern / dislike of this study is rooted in the issues that lead to inaccurate conclusions; let me see if I can outline some of reasons for the inaccuracy, when used in dentistry.

My hope is someday dentists and dentistry can stop calling everything that is not "direct expense overhead", a ***Profit***; that would be huge! To take this issue a bit further, most businesses, outside of the professions, consider all compensations paid to be a part of the business "Operating Overhead." Most businesses big and small pay their Chief Executive Officer (CEO), their Chief Operating Officer (COO), their Chief Financial Officer (CFO), and a few more "Chief's" as a part of the direct expense (operating) overhead before they look at a number called Profit.

Most dentists are not only the COO, they are the CEO, often the CFO, the Chief of the Human Resource Department (HR), a "doer" of Services Rendered, and most dentists can claim a few more responsibility "hats" that they are asked to wear as a part of their job description. Yet, in many dental conversations and Profit and Loss Statements, a line item does not appear to represent the Salary and Benefits received for all they do. And worst yet, most inside and outside our profession call what is left over, after the subtraction of direct expense overhead from revenues, a Profit! It is not ***Profit***; most of it is appropriate compensation for the dentist/owner and all those "hats" being worn!

Kodak did the now classic study on the effects of raising or lowering prices in the late '70's and early '80's. It was based on a business with a 25% Profit Margin after all expenses had been paid. It is a very rare dental practice that can ever get close to a 25% Profit Margin number and therefore any comparison to the Kodak Study is inaccurate. I will admit the Kodak Study can get someone's attention but then it is time to dive deeper into the real numbers to better understand the impact; the story is worse in dentistry than the Kodak Study shows.

I have studied over 10,000 financial statements of dental practices through the years teaching, consulting and coaching in dentistry. Since graduating from Northwestern University Dental School, in 1966, I have listened to and studied with many of the early speakers and writers in Management and Dental Practice Management. When scanning the last fifty to sixty years of data and thought, some interesting patterns emerge.

- When creating a personal budget (*Spending Plan*), a dentist is best counseled to learn to live on “less than what they make” and a "take home pay" from their dental practice which represents 20 – 21 cents of the dollar revenue. Add to that an amount to pay for state and federal taxes and a beginning point for planning a home *Spending Plan* can be 25% of *Practice Revenues*.
- The Doctor Benefits – if we as dentists can think of ourselves as an employee of our practice, regardless of the organizational structure of our business, a range from 9-10% of revenues is common for appropriate benefits (Retirement Plan, Continuing Education, Travel Expense, Medical and Other Insurances, etc.). At this point Total Compensation of the doctor for being the dentist can be 34-35% of *Practice Revenues*.
- Long-term studies have shown that a dentist, over a lifetime of practice can invest between 6-7% of Total Practice Revenues in Capitalization Costs (Capital Equipment, Leasehold Improvements, Re-investing in the Business, and/or Financing Expense) often referred to as Non-Operating Expense. The yearly percentage may vary, yet the lifetime average can be in the 6-7% range.
- If the Operating Overhead is 60% and the Doctors Salary and Benefits are 34%, and the Capitalization Costs (non-operating expense) is 6%, THERE IS NO PROFIT
- If the Operating Overhead is 50% and the Doctors Salary and Benefits are 34%, and the Capitalization Costs (non-operating expense) is 6%, THERE IS A 10% PROFIT
- THE KODAK STUDY WAS CALCULATED BASED ON A 25% PROFIT – AND THAT IS WITH ALL EMPLOYEES, STAKEHOLDERS, AND CAPITALIZATION COSTS BEING PAID FIRST. That is not dentistry!

**An Enhanced Concept of Total Compensation**
Depending on the different responsibilities (“hats”) a dentist incorporates into his/her job description we can increase our understanding of an appropriate compensation, which may come in various forms. My contention is that if an Associate is compensated at 30-35% of the Associate Revenues generated, the Principal Doctor/Owner compensation can be arrived at in consideration of the responsibilities of the Principal. I often ask a question of the Principal dentist, “if we could figure out a way for you to be paid for managing, would you spend more time leading, managing, and developing your practice and team?”

Based on in-depth financial studies of dental practices, as well as other service industries, I believe the individual owner/practitioner’s *Total Compensation* can be at least 34% of what a practice generates in Net Revenues. A starting point for modeling a dental practice can be a *Basic Breakeven* (B/E) *Model* as a “guideline”. This model demonstrates/recommends the individual owner/practitioner’s total compensation be 34% of practice income, that 60% of practice income goes for covering operational expenses (including other employees’ salaries and benefits), and that 6% remains for non-operating expense (business financing/re-capitalization). Please see these percentages as a starting point, not an absolute.

Typically, we see dentists paying themselves whatever is leftover after paying their employees’ salaries and benefits, the practice’s accounts payable, and taxes. Tax–biased thinking, as well as considerations of interest, depreciation, and amortization, tend to drive financial decisions over thoughts of what the practitioner’s fair share of income can be. What I am suggesting is as dentist we can look at our practices like other businesses do, you can first look at services rendered, income, operating expense, and non-operating expense, from a pre-tax point of view, then let your CPA manage your taxes. In this way you can measure the *Operating Efficiency* of the practice and manage toward greater profitability.

Our studies have illustrated that, as practitioners use Financial Management Tools over a number of years, they are able to work their profit margin upward to 10%, then 11%, 12%, 13%, and so on to at least 15% of revenues. The net effect is that over time, they enjoy 34% total compensation off the top and have a growing profit for gain sharing and re-capitalization because their operational costs as a percentage of revenue are going down. In effect, their personal income rises, as does the financial health of the practice. ***As the dentist, manager and owner of a dental practice, it is appropriate to be compensated for each role***. Often as we start out in dentistry, we are not appropriately compensated for our role as dentist, manager, or owner. Yet, nearly sixty years of studies, reported by various investigators have confirmed the ability to manage a practice and earn appropriately. Here is a way to consider appropriate remuneration as the dentist/owner/operator and it includes consideration of your role and responsibilities as the dentist, manager, and owner as a percentage of Total Practice Revenues:

| | |
|---|---|
| For being the Dentist | 34% |
| Fro being the Manager | 6-10% |
| For being the Owner | 6-10% * |

*This money is the money used for Financing and Capitalization (Non-Operating Expense) and typically comes from Net Revenues (Receipts) over time.

When comparing the financial success of a business or practice, within any industry, the truest number and most critical in indicating the operational performance is measured using a term found in the nomenclature of Corporate Finance, referred to as **EBITDA:** **E**arnings **B**efore **I**nterest, **T**ax, **D**epreciation, and **A**mortization. Since in dentistry the investment and financing and the way the Dentist/Owner is paid, differ in so many ways, I created a way to look at the Revenue that was available to the Dentist/Owner after paying the Operating Expenses and prior to paying the Non-Operating Expenses. This number includes any Principal Salary and Benefits (gross salary, draw, dividends, and numerous benefits) paid as a part of Operating Expenses plus the Net Operating Income (which equals Net Revenues minus all other Operating Expenses). This number can be expressed as a percent of the Net Revenue number and called Operating Efficiency %, In the example above the Operating Efficiency % would be 46%-54%. This means 46%-54% of Net Revenues are available to the Dentist/Owner **prior to consideration of Non-Operating Expense (interest, taxes, depreciation, amortization and/or capital lease); this is achievable**. How would it feel to be paid appropriately for your dentistry, your leadership / management, and your entrepreneurial investment? When this is accomplished the practice, in business terms, would be operating with a slight 3-6% Profit and everyone would have been paid for all the tasks and responsibilities they do.

The value of understanding and proactively working to control the various financial components of your practice: practitioner's salary and benefits, employees' salaries and benefits, operational expenses as a percentage of revenues, profit, gain sharing, re-capitalization, etc., are all within your reach. They can become clearer and a part of your understanding as you lean forward into a study of *Financial Management.* Using accurate management numbers to track your “Economic Engine” (your dental practice), you can be paid for being a dentist, manager, and owner of a business.

**The Reality is Much Worst than the Kodak Study Purports**
Kodak Study compared to Dentistry

Kodak (assuming a profit of 25%)

A 2% cut in selling price means you must increase your volume of sales by 8.7% to make the same profit obtained before the price was lowered.
A 3% cut means a 13.6% increase in sales is necessary.
A 5% cut means a 25% increase in sales in necessary.
A 7.5% cut means a 42.8% increase in sales is necessary.
A 10% cut means a 67% increase in sales is necessary.
A 20% cut means a 400% increase in sales is necessary.

Dentistry (assuming a 6% Profit, considering the above conversation)

A 2% cut in selling price means you must increase your volume of sales by 50% to make the same profit obtained before the price was lowered.
A 3% cut means a 100% increase in sales is necessary.
A 5% cut means a 500% increase in sales in necessary.
Any greater cut drastically alters the dentist *Total Compensation*, the ability to *Capitalize* the business and/or appropriately create *Retirement Savings.*

Dentistry (assuming a 10% Profit, considering the above conversation)

A 2% cut in selling price means you must increase your volume of sales by 25% to make the same profit obtained before the price was lowered.
A 3% cut means a 42.9% increase in sales is necessary.
A 5% cut means a 100% increase in sales in necessary.
A 7% cut means a 233.3% increase in sales in necessary.
A 8% cut means a 400% increase in sales in necessary.
A 9% cut means a 900% increase in sales in necessary.
Any greater cut drastically alters the dentist *Total Compensation*, the ability to *Capitalize* the business and/or appropriately create *Retirement Savings.*

Dentistry (assuming a 16% Profit, considering the above conversation)

A 2% cut in selling price means you must increase your volume of sales by 14.3% to make the same profit obtained before the price was lowered.
A 3% cut means a 23.1% increase in sales is necessary.
A 5% cut means a 45.5% increase in sales in necessary.
A 7% cut means a 77.8% increase in sales in necessary.
A 8% cut means a 100% increase in sales in necessary.
A 9% cut means a 128.6% increase in sales in necessary.
A 10% cut means a 166.7% increase in sales in necessary.
A 12% cut means a 300% increase in sales in necessary.
A 15% cut means a 1500% increase in sales in necessary.
Any greater cut drastically alters the dentist *Total Compensation*, the ability to *Capitalize* the business and/or appropriately create *Retirement Savings.*

I must admit, I have a bias concerning dentistry and how it is delivered. My bias and a part of my foundational philosophy is:

> ***"I believe in a uniquely individualized, relationship-based, values-driven, fee-for-service, private practice, one that promotes positive health choices, in which time is allowed to help the patient clarify their best choice while connecting their choice to their expressed values."*** ***RAG***

A 16% Profit in a dental office is very rare indeed! Can you imagine what can happen to the internal operation of a dental office under any of these "Dentistry Profit Profiles" as fees are cut 15%? Reflect on the potential degradation threat to quality of dentistry and to the quality of the "dental experience" with/for the patient and the dentist! It is an incredible threat to "Relationship-Based, Values-Driven Dentistry".

When you come to understand the impact of this data, you will begin to understand why I do not like the Kodak Model used as a comparison – it does not get to the real picture and therefore the Insurance Industry (read Delta) uses the "miss-information" about how profitable dentistry is and thinks they are justified in dropping the fees 15% while raising all of their own compensations in their corporate structure. And for the Dentist – no wonder he/she are running harder and faster! A discount of this magnitude is very hard to recover through increased volume. Another article could be ***The Appropriateness of Stepwise Fee Increases for Practice Sustainability***

Please Note: For a deeper understanding of an appropriate *Fee Strategy Response* look under ***Services Offered*** heading on this website and click ***The Pricing Analysis Report – PAR Offerings.***
For a more in depth conversation concerning the *Economy Circa 2016,* look under ***What's New*** on this website and click the article ***The Economy and Your "Economic Engine"/ Practice***.

**Contact Information:**
*Richard A. Green, DDS, MBA*
*Evergreen Consulting Group, Inc*
*Dedicated to the Learning and Growing Professional*
*Serving Those Who Serve Others*
*2633 Wulfert Road, # 4*
*Sanibel, Florida 33957*
*O: 239.579.0135*
*C: 239.222.9200*
*rich@evergreenconsultinggroup.com*