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Making sense of your home health agency's financial reports: Calculating Your Gross Profit Margin

First in a Series

Many home health agency leaders struggle with how to use accounting information to make financial and operational improvements. Your financial reports need to be understandable, timely, fair and objective, and relevant. This is the first in a series of posts I'm sharing to help my peers navigate, organize, interpret and act on the numbers they crunch.

Calculating your Gross Profit Margin is a first important step. This exercise will help you understand your agency's strengths, weaknesses and opportunities in their totality, by program, by payer and by discipline.

Leaders in the home health industry agree: YOU MUST BE ABLE TO CALCULATE AND UNDERSTAND YOUR GROSS PROFIT.

Terminology:

- **Gross Profit - $:** Expressed as a dollar figure, Gross Profit is your agency's revenue after recognizing costs of the services provided.
- **Gross Margin - %:** Gross Profit expressed as a percentage of Revenue, this is the margin on what we do (and sell to payers)

$$\text{Gross Profit Margin} = \frac{\text{Revenue} - \text{Cost of Goods Sold}}{\text{Revenue}}$$

- **Direct Costs:** The $ costs of all expenses directly related to the cost of the visit to the patient. Direct costs include payroll, benefits, transportation, patient supplies and contracted services for those in your agency who make visits to patients. These costs are sometimes considered "variable costs" and will "directly" increase or decrease as your visits increase or decrease. Direct costs do not include management's time.
- **Indirect/Overhead Expense:** Consider these expenses as the same as Overhead, SGA, Administrative, etc. They include all other expenses associated with your agency. We could break this down further, however, we won't get too technical yet. While they may vary slightly based on the total business of the agency, indirect/overhead expenses should remain rather steady. If a large increase or decrease in business requires addition or deletion of a supervisor, biller, internal manager and/or office staff, these expenses should change.
- **Operating Profit/Margin:** Profit after direct costs and indirect and overhead expenses. This is the income (or loss) from operating activities.

The Squeeze Factors :

- What's your level and rate of Medicare reimbursement; Medicaid; Medicare Advantage; Commercial; Private Pay, etc. What are your margins on each of these payers?
- What are insurance rates? Can your agency do better with specific payers? Call them!

The Squeeze Factors (*continued*):

- Are your rates of reimbursement dropping and cost of visits rising?
- How is your productivity and are you monitoring it?
- What is your Medicare PPS case mix? Are your assessments scored correctly?
- Are there ways technology/software can help your clinicians reduce documentation time?
- Do you need to re-think your agency's mission with regard to certain payers? In other words, your mission may be to care for all patients, regardless of income.

However, if the gross margin you're making from that mission does not contribute to your overhead expenses and profits, it may be time to rethink which reimbursement rates are acceptable and which are not.

- What do employee benefits cost? Have you looked at the cost of benefits and researched more effective program options?
- Do you have the best contracts in place for clinical visiting services and for patient supplies?
- What's happening to your town/local grants – are they starting to tighten up? Make sure bad debts/denials/unbilled items are minimized. Why should you do all that work for nothing?

Here's why you need to pay attention to your direct expenses. Analyze the comparative statement and see how a reduced gross margin has impacted this agency's operating margin.

ABC Agency, Inc.
Profit & Loss Statement
for the period ending June 30, 2017
$ in 000's

	FY'17		FY'16		Change	
Revenues from Patient Services	**$6,750**	**100.0%**	**$6,300**	**100.0%**	**$450**	7.1%
Direct Expenses:						
Wages	3,800		3,450		350	10.1%
Benefits & Payroll Taxes	825		725		100	13.8%
Travel	100		95		5	5.3%
TOTAL	4,725		4,270		455	10.7%
Gross Margin	**2,025**	**30.0%**	**2,016**	**32.0%**	**9**	**0.4%**
Overhead						
Administration	750		725		25	
Occupancy	250		245		5	
All Other	890		860		30	
TOTAL	**1,890**	**28.0%**	**1,830**	**29.0%**	**60**	3.3%
Operating Expenses TOTAL	6,615	98.0%	6,100	96.8%	515	8.4%
Operating Margin	**$135**	**2.0%**	**$200**	**3.2%**	**($65)**	-32.5%

What caused this agency's gross margin to drop from 32% in 2016 to 30% in 2017? Their total direct expenses of $455,000 went up 10% at the same time revenues rose by 7%. The result is that the agency made only $9K gross profit on $450K in increased revenue.

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How much Gross Profit do I need to survive? To grow?

You need at least as much gross profit as you have in all expenses excluding direct expenses. Your gross profit MUST be equal to or more than your Indirect/Overhead expenses. If not, you are losing money.

If you do not have a positive operating margin, then you most likely do not have a positive cash flow (assuming all other things are equal). If you have no positive cash flow, any growth you have will start to cause potentially serious cash issues. Have you ever needed to turn down referrals because you do not have enough cash? It happens. Have you ever experienced a situation where you do not have enough cash for your payroll?

Not enough margin = not enough bottom line = not enough cash = no growth = lose more money = new job

Here's an example of how contributions by each of your agency's programs can be represented in your Gross Profit and Percentage of Gross Margin calculations.

$ In Thousands	Home Health	Non-Medical Home Care	Special Medicaid Program	Lifeline	Other Income	Total
Revenue	$8,200.00	378.0	970.9	286.8	95.0	$9,930.7
Direct Cost	4,625.0	296.7	948.6	235.1	0	6,105,4
Gross Profit	3,575.0	81.3	22.3	51.7	95.0	3,825.3
GM %	43.6%	21.5%	2.3%	18.0%	100%	38.5%

Improving Your Agency's Financial Picture

How can you keep your operating income out of the red? You'll first need to step down variable and overhead costs and trim non-critical expenses. You will also need to boost your Gross Profits by:

- Improving the agency's Medicare case mix
- Negotiating better commercial reimbursement rates
- Improving productivity (e.g. percentage of time in visits, decreasing chart time, admin time, admission time, travel time)
- Honing your service delivery model
- Taking a fresh look at your benefits/workman's compensation
- Reducing bad debts

Coming Next: More Finanancial Tools

In my next posts, I'll be sharing tools to help you calculate cost by visit per discipline, margin by payer and program, a breakeven calculation model and an internal controls checklist.

Need a hand pulling together and evaluating your agency's Gross Profit and Gross Margin picture? Need help in developing financial and operational systems to work more productively? Give me a ring at ***203.691.1319*** *or send me a note* ***here.***

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