Keeping an eye on the health of your business

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Introduction

Are you aware of your pharmacy’s health? In the current business climate, it is essential to know what is happening in your business. Your cash flow needs to be controlled, your inventory levels and stock holding managed, and the coming months planned for. In general, it is important to ensure that your business is financially healthy, and that commitments can be met.

But, how can this be done? Community pharmacy owners are not accountants, nor are they financial experts. The range of indicators to watch out for can be bewildering and complex. The day-to-day running of a pharmacy leaves no time and resources to carry out detailed analyses.

However, a number of key ratios can assist in the managing of a business, and are easy to calculate from existing readily available data. Reviews should take place on a regular basis to ensure that the information is current and relevant. Some indicators, such as sales trend lines, can be compared and reviewed on a weekly or monthly basis. Others require review less often. Find the frequency that works for your business.

The ratios below will examine key areas of your business. Each gives an indication of its financial status. Each set will consider a different aspect of the business, and combined together, create a comprehensive insight into how it is doing.

Gearing ratios

Gearing measures a business’ debt.

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\text{Debt to equity} = \frac{\text{Interest-bearing debt}}{\text{Share capital and reserves}}
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This ratio gives an indication of how much debt is being used to fund the business. Debt must always be paid back, and involves a cost. The higher the debt, the more income is required to service it. If you extend credit to your customers, then a portion of the income each month, or year, needs to be spent in order to pay the incurred interest, and reduce the capital amount outstanding. This occurs before operating expenses have been paid and any profit generated.

Debt is not necessarily adverse, but it must be closely managed to ensure that the level of debt incurred is appropriate, and that the business is able to repay it.

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\text{Total debt} = \frac{\text{Total liabilities}}{\text{Total assets}}
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Working capital management

Working capital is defined as the amount of money required to manage the day-to-day functioning of a business. In order to ensure that there is enough cash to fund the operating cycle (this includes the buying, stock holding, selling and collection processes associated with running a pharmacy), it is important to understand and measure the various factors that affect these components.

To measure this area of the business, use the ratio below:

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\text{Stock days} = 365 \times \frac{\text{Stock on hand}}{\text{Cost of goods sold}}
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This ratio works out how many days of stock are left. Stock is an expense, and needs to be managed to ensure that there is the minimum amount to hand, without compromising the business’ readiness to meet patient needs. There is little need to keep mountains of stock. The majority of wholesalers deliver pharmacy orders within 24-72 hours of receiving the order. Special bulk deals are always available. Smaller suppliers, who operate according to minimum order values and longer lead times, are an exception to this rule. These deals need to be weighed up against the cost of the excess stock, the profitability of the purchase, and the time it will take to sell out the quantities bought. Generally, there is little need to have more than 30 days stock on hand at any one time. However, this is dependent on the location of the pharmacy and the range of items kept.

\[
\text{Debtors’ days} = 365 \times \frac{\text{Debtors}}{\text{Sales}}
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This is a ratio of credit sales. It gives an idea of the volume of account sales (and customers), and the speed (credit terms) with which they pay their accounts. The larger this number, the more money is tied up in extending credit to customers. This ratio needs to be carefully managed as the bigger the number, the more cash will be needed to fund these sales. In effect, if this is more than 30-50 days, then the pharmacy is funding client purchases. Retail pharmacy operates within tight margins, so it is essential that outstanding accounts are actively managed, and that credit policies are implemented and strictly adhered to. This ratio also covers the time it takes for medical aids to pay out claims. Large medical aids and their administrators make payments to pharmacies at least every two weeks. Depending on the medical aid mix involved, this can significantly reduce the overall quantum of this number.
Within the pharmacy environment, it is preferable to be able to view and measure medical aid sales separately to those of cash and account. This allows the pharmacy owner to manage both aspects, and implement different strategies to reduce outstanding days.

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\text{Creditors’ days} = \frac{\text{365} \times \text{Creditors' Purchases}}{\text{Purchases}}
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This provides an indication of how long is taken to pay creditors, and gives indication of the terms that have been agreed to by suppliers. Wholesalers usually apply a strict 30-day credit policy. Invariably, it will not be possible to extend this much beyond 35 days. Some suppliers provide discounts for prompt payment, if settled within 15 days of presentation of the invoice. These discounts are worthwhile and improve the profitability of the business (at the expense of the cash cycle). Each supplier’s terms and conditions should be analysed and used to best advantage. If a discount is available for early payment, ensure that there are not corresponding penalties for late payment. Evaluate the cost of paying early (consider the impact on the cash flow and overdraft costs) against the value of the discount.

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\text{Cash or operating cycle} = \text{Stock days} + \text{debtor days} - \text{creditor days}
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In its simplest terms, this measures the length of time taken from purchase of an item by the business, through to the sale when the business recoups the initial outlay. It is a composite of the above measures. At best, this can be a negative number, when an item is sold before it has to be paid for, i.e. a dispensary item ordered specifically for a customer who pays cash. However, the majority of stock will sit on the shelf before being sold, but the analogy that if you don't have it, you cannot sell it, also holds true. The cash or operating cycle is a measure of the overall cash position of the business, and gives an idea of how much money is tied up in the business. In order to be efficient, it is essential that this number be as low as possible.

A pharmacy’s efficiency can be improved when all aspects of this ratio are managed. Improvements can be made by reducing stock days (buy less, more often), reducing debtor days, and increasing creditor days (this is not always easy, or possible).

**Sales trend**

When is your business the most busy? When is a downturn in turnover expected? How has the business performed relative to the month before, or last year, or the past three years? (Figure 1).

Charting and keeping trends of monthly sales will allow a business’s performance to be monitored over time, and to facilitate a forecast of future cash flow requirements and earnings.

Any variances to the trend should be explained. In Figure 1, when compared to the previous year, the income for August 2010 was considerably above trend. What was different about that month? Is it possible to replicate the conditions to move the entire trend line higher? Anomalies do occur, and should be explained where possible. However, the trend is important. It should be monitored and used as a guide to the overall health of the pharmacy, and as an indicator of what to expect when forecasting growth, turnover and cash requirements.

**Profitability measures**

If a business is not profitable, it will not remain in operation for very long. Determining margins is necessary to ensure that the business’ income is sufficient to meet expenses, and ensure a return for the owner. The markup (and hence profit) on medicines is regulated by the Department of Health. This means that pharmacies cannot increase prices on the majority of their products and services. Margins can be varied in the front shop only.

This portion of the pharmacy consists of:

- Health-related products, such as vitamins, homeopathic remedies and first aid products
- Consumer items such as oral hygiene, feminine hygiene, baby products, shampoos, soaps and deodorants
- Cosmetics and beauty products.

![Figure 1: Yearly sales analysis](image-url)
Each of these various categories have different margins and recommended markups that can vary depending on demand for the product, and competition within the community served by the pharmacy. While these margins can be varied to maximise sales and profitability, the leeway is often restricted by the competition and availability of alternatives.

Retailers use a number of measures to gauge sales and profitability by category and product. Determining net sales per employee can be used to determine staffing levels, and as a benchmark when measuring performance.

Sales per square metre (m²) gives an idea of the average sales based on the size of the pharmacy. Apply this calculation to different departments to determine each department’s average sales. This will give you an indication of how much turnover each department generates, and can be compared to the average for your store. If your cosmetic sales are lower than the average sales/m² for the shop, perhaps you are holding too much stock, or have allocated excessive space to this department. There are many ways to improve the performance of an underperforming department, including changing the product mix and ranges, reducing the allocated space, repricing, and incentivising staff to improve sales.

The concept can be extended to examine the stock holding per department per m². This can be compared to the store’s average. Is too much inventory being held? Cosmetics stock is expensive so a higher-than-average number for this ratio is justified, or is it?

Compare the net sales to the stock holding for the department, and this may indicate if the range and department is worthwhile or is it?

It is helpful to implement a number of verifying measures appropriate to the business, review the information regularly, and act on any variations or changes to the trend. This will ensure that you remain in control.

All of these ratios should be analysed individually and collectively to provide a holistic impression of the pharmacy. Comparisons should be made to previous weeks to give an idea of any changes that have occurred over time. If the ratios are deteriorating, it is advisable to identify the cause, either internal or external in nature, and then to rectify the problem.

These simple measures will ensure that a pharmacy owner is in control of what is happening in the business, and allow swift corrective action to be taken before the business goes into decline.

Bibliography