Cash is King

Manage Your Cash to Protect Your Practice and Grow Your Personal Wealth

by Nathan Hayes, CEPA

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In 2020, the economic shutdowns revealed a little-discussed area of practice finances that is a major predictor of how a practice will fare in a crisis – whether it be a global health emergency or something more temporary like flooding or a fire.

What 'kind' of practices weather 'storms' best? Larger practices, highly profitable practices, and financially disciplined practices.

Having consulted with over 800 practice, I've learned that 'settling' for a small practice because it's simpler and less stressful can prove to be a more stressful option, because smaller practices have less ability to build robust cash reserves, for the practice or its owner. Even large practices that settle for perennially low profitability and cash flow greatly restricted their ability to get through a crisis.

What follows is a playbook for cash flow and cash discipline, for practice finances and owners' personal cash cushions. In times of crisis is that CASH IS KING. When the unprecedented shelter in place orders came down April and May, 2020, the first thing owners did was check their bank accounts and ask: how long will this cash last me?

Let's consider three areas of cash management for independent optometry practices

1. How much cash should you keep in your practice
2. Cash flow and its implications on HOW you should pay yourself
3. The impact of cash discipline on your lifestyle and net worth

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I. GOLDILOCKS AND THE THREE BANK BALANCES

Cash reserves are a funny thing. A couple of years ago, I was working with a high net-income practice with $1.6 million in collected gross revenue, and the owner was telling me he was stressed about paying everyday bills. After going through a triage of cash flow issues it turns out the only problem was that he kept his checking account balance way too low. Even large practices can trip up over their cash balance.

Therefore, you should just leave a ton of money in your practice, right?

Well, no. in 2019, I had lunch with a practice owner who almost lost $1 million on his practice's sale price when he sold, BECAUSE he had too much cash in his practice. (To be fair, it WAS a big practice – total sale price ended up being around $7 million.) The buyer (private equity backed) assumed the practice needed all the cash he kept in it and vastly undercalculated the true cash flow of the business.

I often tell owners they should take a distribution and draw down their practice checking account. Which IS good advice, though it doesn't seem that way in the middle of a global pandemic and almost all independent practices are shut down (except for emergent care).

I admit, I had to sheepishly accept the feedback I got at least ten times in the wake of Coronavirus shutdowns: "Hey Nathan, remember when you told us to take a $100,000 distribution out of our practice? Well… we're really glad we didn't follow that advice." And OK, just like some people lucked out by turning their portfolios to cash just months before the 2008 financial crisis, many people feel vindicated by the current crisis.

But there is a flip side. One owner ruefully told me that he wished he'd taken my advice; he was worried that an auditor might not agree that he needed a government loan when he held four months of expenses in the practice checking account.

So how much cash should you leave in your practice?

Several years ago, I put this question to J.R. Armstrong, a CPA from May & Co. CPAs in Vicksburg, MS. They may have the largest specialty practice serving independent optometry in the country. His advice is that, conservatively, a practice should keep one month's expected expenses in the checking account.

Let's look at how that math works. Consider the following practice's financials:

Gross Revenue	**$1,500,000**
Cost Of Goods	$420,000
Non-OD Staff Investment	$330,000
COGs and Staff Expense %	**50.0%**
Occupancy, Equipment, Marketing & General Office Overhead	$300,000
Total Operating Overhead	**$1,050,000**
Practice Net Income	**$450,000**
Practice Net Income %	**30.0%**
Owner Compensation	$125,000
Associate Compensation	$150,000
EBITDA	**$175,000**
Debt Service	$0
Owner's Pre-tax Income	**$300,000**

** Owner's Income + EBITDA*

The annual expenses are the revenues less the owner's income: $1,500k - $300k = $1,200k ($1.2M). And one month's expected expenses are $1,200k ÷ 12 months = $100k. And that's a conservative number: if – in ordinary times – you track the monthly change in your checking account, this practice would probably have closer to a $70,000 swing month-to-month.

"But!" – you may protest – "*what about the pandemic!?!? We were shut down for 3 months!"*

Well, let's take the P&L from above and see how it would have fared through a months-long shutdown. Assume you zero out the revenues and furlough all the staff – including the associate. Assume Cost of Goods goes to zero too (I know most practices still sold contact lenses during the shutdown, but for the sake of the illustration…).

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Here's the annual P&L, with no revenues, no cost of goods, and no non-OD staff or associate OD:

Gross Revenue	**$0**
Cost Of Goods	$0
Non-OD Staff Investment	$0
COGs and Staff Expense %	**0.0%**
Occupancy, Equipment, Marketing & General Office Overhead	$300,000
Total Operating Overhead	**$300,000**
Practice Net Income	**-$300,000**
Practice Net Income %	**0.0%**
Owner Compensation	$125,000
Associate Compensation	$0
EBITDA	**-$425,000**
Debt Service	$0
Owner's Pre-tax Income	**-$300,000**

** Owner's Income + EBITDA*

The bleed rate becomes $300,000 per year, which is $25,000 per month. <u>You could fund a four-month shutdown with that $100,000 reserve</u>.

Without showing my work, keeping half the staff (but furloughing the associate OD) would trim average monthly expenses from $100,000 to $38,750, meaning <u>you could cover about two and a half month's expenses</u>.

Cash vs. Liquidity

Did the COVID-19 shutdowns changed my view of cash reserves at all? Yes, but not in terms of cash in the checking account. In addition to an appropriate cash reserve, I also think getting more liquidity is a good idea. (Liquidity means cash and/or credit.)

I now recommend that practices have an additional one month's expenses available on a line of credit – or at least have some additional cushion in the form of a credit line. And I do mean available credit; a maxed-out credit line doesn't count. (Besides, you should be retiring credit line within a month or two of drawing on it, at most.)

Many owners I work with don't want to take on more debt. But remember: credit lines are merely access to cash. You won't start paying interest until you draw against the line. The fee to keep a line open is minimal. And it's better to get one established when business is good. The worst time to ask a bank for money is when your business is distressed and *needs* it.

Supplement modest practice reserves with large personal reserves

One of the pressures many owners felt in the midst of the shutdowns was that in addition to the practice's need for cash to pay the bills it still had to pay, THEY needed cash out of the practice to cover their personal expenses. There's always a natural blending between the practice's finances and its owners' finances, but there are two reserve funds an owner needs: practice AND personal.

I asked Natalie Hayes Schmook, a certified financial planner who serves independent optometric practice owners, about personal reserves (full disclosure, she's also my twin sister). Here is her advice:

- If there are two earners (from different sources) in your household, you should have 3-6 months of personal expenses in cash, in a separate savings or checking account.
- If you are the sole owner for your household (or your spouse also works in the practice), that emergency fund should be 6-12 months.

Take heart, you only need enough to cover the bare-bones expenses (car note, mortgage, food, utilities). Obviously, you could also include your dinner out and summer vacation funds, but how many of us actually took a paid vacation in the midst of COVID-19? Having a solid personal reserve gives you freedom run your practice as a business that stands or falls on its own. Navigating a crisis is just easier if the practice doesn't HAVE to pay its owner(s) in addition to paying staff, vendors, rent, etc.

II. TIMING IS EVERYTHING – HOW AND WHEN TO PAY YOURSELF

Most practice owners reading this severely – if not completely – depleted their practice's cash reserves during the 2020 pandemic shut-downs. Ironically, by the fall many practices ended up with a ton of cash after their PPP loan was forgiven. Having the right process will help you right-size your cash reserves and then maintain healthy reserves going forward.

Owners generally take their income in two or three ways: as salary, bonuses or distributions. This will vary based on your business form – especially if your practice is a C-Corp. Single owner practices will likely only take salary and distributions, while I recommend partnerships take their income as a base salary with a quarterly bonus and cash flow distribution.

Owner's salary – are you being 'pennies wise and pounds foolish' about payroll taxes?

If your practice is a pass-through entity for tax purposes (an S-Corp or an LLC), you know that you have a choice about where you set your salary. Many owners have chosen to take a low W-2 salary out of the practice in order to avoid Social Security taxes, 12.4% of the first $137,700 you earn in 2020, and Medicare taxes, 2.9% of all W-2 income, with a 0.9% surtax for income over $200,000. (You pay 7.65% of your employees' wages and they pay 7.65% for themselves; you pay both for your salary as the business owner).

IRS guidelines call for owners of pass-through businesses to pay a 'fair market wage' for the services they provide their businesses. According Review of Optometry's 2019 Income Survey, the average employed OD earned $132,967, $126,887 for associates in OD or MD practices. Owners also have management and administrative roles in their practices. Let's assume a fair market wage for a full-time OD in a private-practice setting is $130,000 per year. How much will an owner save in taxes by taking less than that in W-2 income?

Fair Market Wage	Actual W-2 Income	Difference	Tax Savings
$130,000	$100,000	$30,000	$4,590
$130,000	$75,000	$55,000	$8,415
$130,000	$50,000	$80,000	$12,240

The payroll tax savings are modest but real; they'll certainly cover a nice weekend away even at the smallest amount. But what are the trade-offs? There are four main risks you bear by declaring less income as W-2 income:

Risks of Avoiding Payroll Taxes

1. **Less in Unemployment benefits if you need them.** If you get injured and are unable to work, your unemployment is based on your declared wages.
2. **Less Social Security.** In retirement, your social security income is based on your lifetime withholdings on your income
3. **401k and Profit Sharing.** The less salary you take, the less ability you have to leverage tax-preferred savings vehicles to both lower your taxable income and build wealth in a tax preferred investment account.
4. **Audit risk.** If you pull an audit, is this modest tax savings worth risking deeper scrutiny by the IRS?

And in 2020 we discovered a *fifth risk* of not taking a fair market wage: owners who took less than $100,000 in W-2 income weren't eligible for the maximum relief amount the Paycheck Protection Program provided.

My preference is that owners take a fair market salary for their services to their practices as both optometrists and executives. Talk with your CPA about the right mix of W-2 income and regular draws. But the key point is to take a regular wage that supports your ordinary expenses.

Ideally, this wage is one-half – two-thirds at most – of your expected total pre-tax income. This does two important things:

1. **It takes pressure off the practice's cash flow.** Let's say you reasonably expect to earn $240,000 per year, pre-tax. You could take $20,000 a month, but is that realistic? Revenues and expenses vary month-to-month. This will cause your practice to run negative cash flow some months.
2. **It opens up the path to building true wealth.** By living off less than the total earnings of your practice, you can save and invest the remainder. Your practice's primary value as an asset is the income it provides, much more than its equity value at the time you sell.

This is especially important in partnerships, because the need to provide an income premium to multiple owners usually puts additional pressure on cash flow.

Take Distributions Disciplined by Cash Flow

In their layman's guide to small-business finances, Simple Numbers, Straight Talk, Big Profits!: 4 Keys to Unlock Your Business Potential, Greg Crabtree and Beverly Blair Harzog spell out the Four Forces of Cash Flow in any small business:

1. Taxes
2. Debt Service
3. Cash Reserves
4. Shareholder Distributions

And this is the process for making distributions: recognize that three entities come before an owner (shareholder) when it comes to distributing excess cash: the government, the bank, and the business.

Here's the path to taking a distribution. Every month, you should be putting cash in a separate account to cover your quarterly estimated tax bill (you should be talking with your CPA twice a year about expected taxes and how much to set aside – more frequently if your practice undergoes a dramatic change, like rapid revenue growth).

Every month, you should be making your monthly payments on outstanding loans (more on prepayment later).

Finally, you should have a regular cadence for taking distributions. I like to do it quarterly, but it could be a monthly or semi-annual cadence as well. At whichever interval you choose, if your checking account has more money than your cash reserve target - after you've made all your loan payments and set aside money for taxes - take a distribution. If there's less than your target, skip the distribution and let the cash build back up.

Put the distribution towards one of two things: savings and investment, or additional debt payments. Where to start depends on your risk tolerances and opportunities. I prefer savings, but if you're going pre-pay debt, at least focus on non-performing and non-deductible debt: your car and student loans (student loans interest deduction tails off for anyone making over $85k per year as a single filer or $170k as a joint filer).

> Disciplining your distributions to the practice's cash reserve balance prevents you from 'inadvertently' taking out so much income that your practice runs negative cash flow.
>
> Disciplining yourself to regularly take distributions also prevents the practice from having excess cash to spend on whatever new instrument or frame line catches someone's fancy.

III. KNOCK-ON EFFECTS OF CASH DISCIPLINE

My hope is that you have a picture now of how taking a reasonable salary from your practice that's well below your expected pre-tax income will help your practice grow and maintain its cash reserves, and helps you apply true excess cash to improving your personal balance sheet through savings and debt reduction.

Beyond those benefits, let's spotlight a couple of other reasons that being cash-disciplined makes for a better practice and personal life.

1. **Personal budgeting:** From time to time, I'll work with a practice owner who treats his practice like an ATM, and often these owners will end up spending more in their personal life than the practice can afford.

   Having a regular income from the practice that is LESS than the practice is expected to generate in net income makes it easy to live within your practice's means and your personal means.

2. **Practice budgeting and benchmarking:** It also makes it easier for the practice to know what expenses it needs to carry and how much cash it needs in reserve. If you're running personal expenses through the practice willy-nilly, how will you know the practice's true expenses and profits?

   A clear dividing wall between personal expenses and practice expenses also makes it easier to assess the practice's overhead benchmarks and overall profitability. Again, unless you proactively label personal expenses flowing through the practice, those costs will make expenses look higher than they really are.

3. **Nurture the value of the practice:** My experience with optometric practices owners is that they tend to either under-value or over-value their practice. Wherever you fall on that spectrum, this much is true: the value of your practice is driven by the cash flow a future owner can expect the practice to provide. As a rule, buyers don't pay for cash flows they can't see in your financials.

   If you bury a ton of personal expenses in your P&L to lower your tax bill or just out of sloppiness, you will negatively impact the asset value of the practice. It's true that delivering consistently exceptional service is the biggest predictor of revenue growth in practices, and the best thing you focus on day-to-day. Beyond service, owners who have financial discipline also tend to grow faster and more profitably.

One other note: in addition to keeping personal expenses out of the practice's finances (which leaves cash in the practice), being disciplined to take cash OUT of the practice also preserves the value. Remember the case I cited before where an owner increased his offer price by showing his private equity buyer that $200k of the cash in his checking account was 'excess' cash. Leaving too much cash in your practice masks the true cash flow a buyer can expect.

4. **Protect your family and estate:** About 50% of business owners will be forced to sell their business before they're ready to, according to Chris Snyder, CEO of the Exit Planning Institute in EPI's State of Owner Readiness Survey™. Death, disability, divorce, disaster and even simple disagreement between partners can force a business to sell on short notice.

   Keeping clean finances and being disciplined with cash reserves and distributions will make it easier to sell your business for close to its full value should you need to move quickly.

5. **Open door to building true wealth:** Finally, by disciplining yourself to live off less than your practice's true profitability, you can direct the excess cash to building wealth OUTSIDE the practice. While practices do have meaningful value as assets, they aren't generally worth enough to fund their owners' retirements.

   True freedom is being able to treat your practice's asset value as an added bonus when you're ready to retire. If you have any idea of being able to retire early or provide generously for your retirement and heirs, you must save early and often at every stage of your career. Healthy systems for cash management are essentially to saving and wealth-building.

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IV. ELEPHANTS ARE EATEN ONE BITE AT A TIME

Often, when I give a cash-strapped owner a cash reserve target, even if it's just $15k or $20k, they can't imagine ever getting there, even as they know it would take a huge burden off juggling bills and payroll each month.

Here's my advice: you don't have to fix everything at once! If it takes six, twelve or even eighteen months, so be it! The process to build up a health cash reserve remains much the same:

1. Live off a salary from the practice that is half to two-thirds of the practice's expected net.
2. Set aside money each month – in a separate account – for quarterly estimated taxes
3. Make the ordinary payments on outstanding loans. Do not make extra or pre-payments.
4. Take a distribution monthly, but instead of waiting until you accrue your pre-pandemic reserve target, let the target grow each month.

For example, let's say your cash reserve target in ordinary times would be $50,000, but you're down to $15,000 in reserves. Let your target grow by $3,000 per month, and in 12 months you'll be back up to $51,000 (12 months x $3,000 = $36,000; $36,000 + $15,0000 = $51,000).

Also be sure to build your personal reserve back up before you start making elective purchases!

The right things work in good times and bad

The shutdowns that resulted from the COVID-19 pandemic stress-tested practices from coast to coast in ways that we haven't seen in generations, perhaps ever.

Whatever the future holds for your family and your practice, being disciplined with cash and liquidity, coupled with personal savings, will help de-risk your finances and open the door to true financial independence.