Profit First

The Profitable Doctor

Eradicating Practice Poverty

Where You May Be Now

You know who he is, the guy with the fancy new car (it's a lease), kids in private school, living in a nice house with a pool, in the nicest neighborhood. The problem is, this guy is probably living beyond his means, up to his eyeballs in credit card debt, with very little in savings, and likely one month away from bankruptcy.

For many of us, we run our businesses the same; living beyond our means, buried in debt, struggling with cash flow and forcing the business to live on the scraps, assuming there are leftovers to begin with.

Too often we rob from our practices, keeping everything for ourselves (i.e., too high of owner's compensation) depriving our business of the critical resources to survive (cash)!

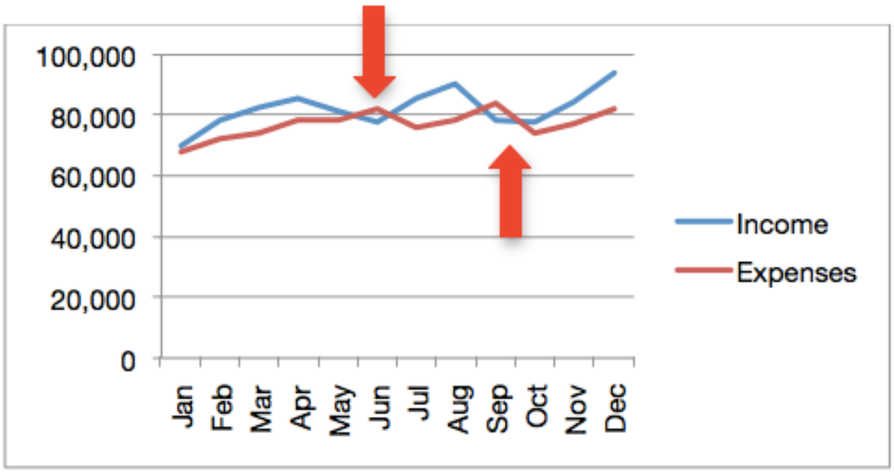
Studies show only half of all businesses survive, while the other half struggle to makes ends meet. Most practices are surviving insurance check to insurance check, are run by stressed out doctor owners, and rarely experience any kind of real profit or healthy cash flow.

Fortunately, it doesn't have to be this way. Our businesses don't have to be a source of stress, anxiety and frustration. Yes, it's possible to have the practice of your dreams without it practically killing you.

Fortunately, there's a better way to run our practices that will improve our cash flow, decrease stress and allow us to enjoy why we decided to get into business for ourselves in the first place. It's going to take some effort to understand how the system works, but if you'll make the commitment, it's practically guaranteed you will immediately see an increase in profit in your practice, day one!

If you're tired of living insurance check to insurance check wondering if the money will be there to meet payroll, or if you simply want to free up some cash so you can take that well deserved vacation, this system is for you. If you're like most, what you've been doing isn't working, so let's get busy! After all, what do you have to lose!

The Cash Flow Pinch



Most money problems occur when income slows down or when expenses unexpectedly increase. When both occur, at the same time, you have a cash flow pinch that can result in a disaster.

A good month or quarter can convince us that we're doing everything right. Then we start spending, convinced that we've got this; business is booming, and we're on top of the world. After all, this is the new normal, right? Then we have a slow month, hit the panic button, and scramble to cover the bills by slamming on the breaks.

When we get into financial trouble like this, we hustle to increase revenue to cover the new expenses that we've now committed ourselves to (i.e., new technology, equipment, third party contracts, etc.) This cycle causes our cash flow to roller coaster and spin out of control.

So we try to outgrow your financial problems: increase collections, acquire another location, buy more equipment/technology, etc. The result is even more expenses and financial stress.

When we focus only on growth, we simply increase expenses. As our collections grow, we inherit new expenses to support that growth. Unfortunately, growth doesn't guarantee profits, only headaches.

Bank Balance Accounting

Most of us run our businesses by "bank balance accounting". We are in the habit of checking our bank account balances daily, often multiple times in a single day.

When there's money in the bank, we think things are fine. We congratulate ourselves for having a great business mind. We celebrate our successes, often by spending money, investing in more technology, celebrating with a fancy dinner.

When there's no money in the bank account, we panic, get stressed, start yelling at our staff to sell more, get depressed, discouraged, frustrated and have night sweats. We're in survival mode, a bad place to be to make wise business decisions.

With bank balance accounting, we often see our money in a single account, a pool of money whose primary purpose is to be spent on operating our business. And spend it we will. Just like if we have $10 in our pocket, we'll spend $10. If we have a full plate of food, we'll consume it. When we are in the habit of looking only at our bank balance in our single account, we have no controls in place for managing how we should be spending. And no matter how much more we make, we'll find a way to spend it!

A New Strategy

GAAP (Generally Accepted Accounting Principles):

Sales – Expenses = Profit

Our accountants determine our "profit" simply to calculate how much we owe in taxes.

We need to think of profit as cash in the bank, the reward for having the entrepreneurial spirit, guts, drive and ambition to start and run our own business.

The *Profit First* Accounting Formula:

Sales – *Profit* = Expenses

Profit is a Choice

Profit is not a desire, it's a ***decision***.

Profit is not a result, it's an ***action***.

Profit is not an event, it's a ***habit***.

Profit is a **choice**, made possible by reverse engineering the traditional GAAP equation.

The Four Core Principles of Profit First

1. Use small plates
2. Serve sequentially
3. Remove temptation
4. Create a rhythm

Use small plates – *Periodically disperse money from the* ***Income*** *account to the other various accounts based on previously established percentages. Accounts with less available (e.g. our* ***Op Exp*** *account) will mean we spend less.*

Serve sequentially – *The order matters. Always allocate the money in the proper order. Don't pay your bills first and hope that something is left over. If there's not enough in your* ***Op Exp*** *account to cover your bills, there's something fundamentally wrong with your business. You, no doubt, have expenses that you can't afford.*

Remove temptation – *Create accounts that are out of sight and mind. Move the tempting accounts into a place that is difficult to access.*

Create a rhythm – *Create a consistent pattern. Do your allocations twice monthly (10th and 25th). More frequently may be necessary, and that's OK.*

Parkinson's Law

The demand for something expands to match its supply.

Parkinson's Law triggers two behaviors:

- ✓ Frugality
- ✓ Innovation

We need to intentionally make less available to run our businesses (operating expenses). The result will be that we will become more **frugal** and more **innovative**.

By taking our profits first, we force ourselves to reduce our operating expenses by being both frugal and innovative.

The Primacy Effect

We place a greater value and importance on those things we encounter first, i.e., our first impression. By taking our profit first, we place added importance on profit and less importance on operating expenses. We are prioritizing what needs attention. We move our focus from trying to figure out how we are going to pay the bills to how we are going to take a profit.

Becoming Profitable Now: A Step by Step Guide

Step 1 – Create Five Foundational Bank Accounts

Contact your bank and let them know you want to set up 5 "no fee" (i.e., FREE!) checking accounts. You may only need four since you are most likely already operating out of one account. If your bank won't give you these accounts for free, find another bank.

If you are already operating out of one account, rename this account your **Income** account and open 4 additional, linked checking accounts.

Name these accounts (for now) as follows:

- ✓ Income
- ✓ Profit
- ✓ Owner's Comp
- ✓ Tax
- ✓ Operating Expense

(If this sounds familiar, it should because we are using grandma's old envelope system of allocating funds to each account, but using our bank accounts instead!)

Step 2 – Transfer 1% into your Profit Account

Once you've set up your 5 accounts and given them temporary names (as instructed above), transfer 1% of what is currently in your general operating account (your new "Income" account) into the new Profit Account (after accounting for any outstanding checks, of course). We want to get something into this account as soon as possible. Consider it a small "win". If you have $100,000 in your new Income account, transfer $1,000. If you have $25,000, transfer $250. If you have $100 in that account, transfer even a dollar! It's important to start getting a sense of how it feels to take a profit. You deserve it!

Step 3 – Create Two "No Temptation" Accounts

Call these accounts:

- ✓ Profit Hold
- ✓ Tax Hold

Find a <u>*different*</u> bank or credit union that makes it somewhat difficult to get to your money and set up two <u>savings</u> accounts. Don't use the same bank that you used to set up your 5 core accounts. You want to create a barrier to easy access and remove temptation to getting to these funds. The money in the **TAX Hold** account is not yours, it's Uncle Sam's. The **PROFIT Hold** money is yours. We'll discuss how to get your hands on it and what to do with it later.

Link these two accounts to your primary accounts at your first bank so you can easily transfer money into them. (But not out of them!)

Once we get rolling, we'll be transferring from the **Profit** and **Tax** core accounts to their respective **Profit HOLD** and **Tax HOLD** accounts (more on this later).

Step 4 – Determine Your CAP and TAP

Target Allocation Percentage (TAP): Analyzing Where You Are…And Where You're Going

The *Instant Assessment* is a quick and easy tool to give you an idea of where you currently stand as a business. It will help you understand how you have been taking profits (if any), how you have been paying yourself, paying your taxes, and managing your operating expenses.

Here's what you'll need to complete the Instant Assessment:

1. Your Total Collections for the last full year. If you don't have it on your Profit and Loss statement, contact your accountant. They should be able to provide that number for you. If all else fails, go through your bank statements for the last full year and add up all of the total deposits (income from your business only) to determine your total collections.

2. The amount of true **Profit** that your company took during that same year. This is not the amount of money that you paid yourself in compensation or took as a distribution as the owner (we'll get to that in a moment). This is how much your company took in profit. If you are like most small businesses, this is probably zero.

3. The amount of money you took as **Owner Compensation**. This is everything you paid yourself either as a W-2 salary, draw or distribution.

4. The total amount that your company paid in **Taxes** for the year on your behalf. This is NOT the amount of taxes withheld from your W-2 salary, but rather the amount that the company paid for you. Examples include quarterly tax estimates, year-end CPA tax bill surprises and various property taxes. If you don't have access to that information, contact your accountant. They should be able to provide it for you.

5. The total amount spent on operations (overhead), also known as your **Operating Expenses**, which includes your cost of goods sold, people, place and things (everything else). You should be able find this on your Profit and Loss statement. If you don't have it, simply subtract what you took in profit, owner's compensation and paid in taxes from your total collections. What's left is a good estimate of your operating expenses.

Now, complete the grid below by following the instructions provided.

	$	%	TAP	Target $	$ Diff
Collections	A1	100%			
Profit	A2	B2	10%	D2	E2
Own Comp	A3	B3	15%	D3	E3
Tax	A4	B4	10%	D4	E4
Op Expense	A5	B5	65%	D5	E5

Column A

A1 – Enter your total annual collections for your most recent full year

A2 – Enter your profit (in dollars) from the same period (most likely this will be 0.)

A3 – Enter your total compensation (owner's comp) for the year

A4 – Enter the total amount you paid in taxes for the year

A5 – Enter the total of everything you spent on expenses including COGS, people, place and things. Also include all expenses for bank loans, practice notes, HELOCs, equipment expenses, and any other expenses related to operating your business. For simplicity, this should include everything that wasn't spent on owner's comp, taxes or taken as profit. If you're not sure, simply subtract your profit, owner's comp and taxes from your collections and enter that number as your operating expenses.

Column B

B2 – Divide A2 by A1 to determine your historical % Profit (A2/A1 = B2)

B3 – Divide A3 by A1 to determine your historical % Owner's Comp (A3/A1 = B3)

B4 – Divide A4 by A1 to determine your historical % Taxes paid (A4/A1=B4)

B5 – Divide A5 by A1 to determine your historical % Operating Expenses (A5/A1=B5)

Column C

This column is pre-populated with suggested targets (TAP) percentages based on an efficiently run practice. These values can, of course, be changed based on your individual goals and circumstances. These are merely provided as suggestions for shooting for what should be considered achievable goals.

Column D

D2 – D5: Multiply each corresponding TAP percentage by the Collections (A1) to populate cells D2 through D5

Column E

E2 – Subtract D2 from A2 and enter into cell E2. If negative number, place in parentheses

E3 – Subtract D3 from A3 and enter into cell E3. If negative number, place in parentheses

E4 – Subtract D4 from A4 and enter into cell E4. If negative number, place in parentheses

E5 – Subtract D5 from A5 and enter into cell E5. If negative number, place in parentheses

Example of Completed TAP Grid:

	$	%	TAP	Target $	Diff $
Collections	A1 $1,250,000	100%			
Profit	A2 $0	B2 0%	10%	D2 $125,000	E2 ($125,000)
Own Comp	A3 $175,000	B3 14%	15%	D3 $187,500	E3 ($12,500)
Tax	A4 $38,000	B3 3%	10%	D4 $125,000	E4 ($87,000)
Op Expense	A5 $1,037,000	B4 83%	65%	D5 $812,500	E5 $224,500

Current Allocation Percentage (CAP): Small Steps

Now that we've created our targets, where we want to be, we need to take a closer look at where we are and start the process of taking small, incremental steps toward reaching our goals. It's important to realize that you don't want (or need) to make big changes fast. It's better to make gradual changes so that 1) the changes will be so small that you don't really feel them; 2) you begin to create a pattern and habit of allocating your percentages on a routine basis.

To determine our first small steps, we'll complete the grid below.

	$	Day Zero (%)	Adjust	Day One	Target $	Diff $
Collections	A1	100%				
Profit	A2	B2	C2	D2	E2	F2
Own Comp	A3	B3	C3	D3	E3	F3
Tax	A4	B4	C4	D4	E4	F4
Op Expense	A5	B5	C5	D5	E5	F5

Column A

A1 – Enter your total annual collections for your most recent full year

A2 – Enter your profit (in dollars) from the same period (most likely this will be 0.)

A3 – Enter your total compensation (owner's comp) for the year

A4 – Enter the total amount you paid in taxes for the year

A5 – Enter the total of everything you spent on expenses including COGS, people, place and things. Also include all expenses for bank loans, practice notes, HELOCs, equipment expenses, and any other expenses related to operating your business. For simplicity, this should include everything that wasn't spent on owner's comp, taxes or taken as profit.

Column B

B2 – Divide A2 by A1 to determine your historical % Profit (A2/A1 = B2)

B3 – Divide A3 by A1 to determine your historical % Owner's Comp (A3/A1 = B3)

B4 – Divide A4 by A1 to determine your historical % Taxes paid (A4/A1=B4)

B5 – Divide A5 by A1 to determine your historical % Operating Expenses (A5/A1=B5)

Column C

Enter your new CAP% increase/decrease goals. Start easy, 1% increase is a good place to start for your Profit, Owner's Comp and Taxes. Remember, for each % increase there needs to be a corresponding decrease in Op Exp. Enter into cells C2 through C5.

Column D

D2 – D5: Enter your new Day One CAP % for each of the cells D2-D5.

Column E

Multiply each corresponding Day One CAP percentage (Column D) by the Collections (A1) to populate cells E2 through E5 (Target $)

Column F

E2 – Subtract E2 from A2 and enter into cell F2. If negative number, place in parentheses

E3 – Subtract E3 from A3 and enter into cell F3. If negative number, place in parentheses

E4 – Subtract E4 from A4 and enter into cell F4. If negative number, place in parentheses

E5 – Subtract E5 from A5 and enter into cell F5. If negative number, place in parentheses

The goal is to increase each CAP every quarter by 1% (Profit, Owner's Comp and Tax) and decrease Op Exp by 3% until you reach your TAP.

Profit CAP – Start with 1% if your company is like most and is not in the habit of taking a profit.

Owner's Comp CAP – Make sure you are paying yourself a fair wage, similar to what it would cost your company to hire someone to do your job. Don't overpay yourself though. The other parts of the business need vital resources also. You may find that you are overpaying yourself and may need to adjust your own standard of living to fit your new system until you can afford to increase your compensation. Increase your CAP by 1% unless you have exceeded your TAP.

Tax CAP – The idea here is to have your company not only pay the company's taxes, *but also your taxes.* You do, after all, own the company, and deserve to have the company pay your taxes for you. If you've been paying no taxes other than what's been deducted from your W-2 wage (since you haven't had a profit, it's possible), enter 1% as your CAP and work toward your TAP. If you know your tax percentage, slowly begin increasing it by 1% until you reach the recommended TAP for taxes.

Operating Expense CAP – This is the only percentage that we will be actively trying to *decrease*. We are, after all, trying to become more profitable, and we'll achieve this by cutting our expenses. Decrease your Operating Expense CAP by the same % that you increased it for your Profit, Owner's Comp and Taxes. For instance, if you increased your Profit, Owner's Comp and Taxes each by 1%, then you'll need to decrease your Operating Expenses by 3%.

Example of Completed CAP grid:

	$	Day Zero (%)	Adjust	Day One	Target $	Diff $
Collections	A1 $1,250,000	100%				
Profit	A2 $0	B2 0%	C2 1%	D2 1%	E2 $12,500	($12,500)
Own Comp	A3 $175,000	B3 14%	C3 1%	D3 15%	E3 $187,500	($12,500)
Tax	A4 $38,000	B3 3%	C4 1%	D4 4%	E4 $50,000	($12,000)
Op Expense	A5 $1,037,000	B4 83%	C5 -3%	D5 80%	E5 $1,000,000	$37,000

Notes:

On the 10th and 25th of each month, transfer your % allocations into each sub account from your Income account. Immediately transfer from your Profit and Tax accounts into your Profit Hold and Tax Hold accounts. Pay all bills out of your Op Exp account.

Step 5 - Naming Your Bank Accounts

Name your bank accounts based on both your **CAP** and **TAP** information. For example, the **PROFIT** account might be named:

Profit 1% TAP 10%

…where 1% is your current CAP and 10% is your TAP.

If your bank doesn't allow you to name your accounts using symbols, just leave off the % signs.

Profit 1 TAP 10

All seven accounts might look something like this:

Bank #1	**Bank #2**
Income *7645	Profit Hold *0858
Profit 1 TAP 10 *9645	Tax Hold *7364
Owner's Comp 8 TAP 15 *5625	
Tax 1 TAP 10 *6345	
Op Exp 90 TAP 65 *4253	

Step 6 – Making Your Allocations

If you have been operating out of one bank account (like most businesses do), you should have already renamed this current operating account as your **Income account**. Determine the amount of any outstanding checks and leave that amount in the account. Transfer the balance into each of your other accounts based on the percentages allocated for each. From now on, you must pay all of your bills out of your **Op Exp** account and only use your **Income** account to deposit all income.

On the 10th and 25th of each month, transfer from your Income account, into each of your Profit, Owner's Comp, Tax and Op Exp accounts, your allocated percentages.

Immediately, transfer the funds from your **Profit** and **Tax** accounts into your "No Temptation" **Profit Hold** and **Tax Hold** accounts at your second bank.

Pay all of your business's expenses on the **10th** and **25th** out of your **Op Exp** account. By making both your income transfers and paying your bills twice a month, you will start to get into a rhythm which will help you better understand how money flows both into and out of your business (cash flow!)

Quarterly Distributions

Each quarter, transfer 50% of the balance in your **Profit Hold** (Bank 2) account to your personal account. This is your money to keep and do as you please. Buy yourself something nice, take a vacation, invest in your retirement, have a nice bottle of wine, etc. This is your reward for having the courage to start and run your own business. This is the little extra for having the guts, perseverance and fortitude to take a risk on yourself in the first place. Enjoy it! The other 50% remains in the **Profit** account. This is your "rainy day" account for your business to be used for emergencies, investment in new technology, etc.

From the **Tax Hold** account, pay your quarterly taxes. If you've underestimated your tax bill, you'll need make up the difference from your **Profit Hold** account, and increase the % adjustment on the next quarter. If you've over-contributed to your **Tax Hold** account, congratulations, you've just earned yourself a little more profit. (Although it might be wise to let that money sit in case you underestimate your taxes in the future.)

Step 7 – Destroying Your Debt

Too much debt can be the death of a business. It is a poison that will destroy the profitability of your practice and can create enormous stress for the business owners. In fact, debt is the single biggest drain on your cash flow and will prevent you from reaping the rewards of business ownership. If debt is allowed to accumulate, it can eventually destroy your cash flow completely and potentially threaten the existence of your business. Eliminating debt will improve not only your cash flow, but also decrease your stress because you will now have the necessary capital to safely and comfortably allocate to your **Profit, Owner's Comp** and **Tax** accounts what they appropriately deserve.

The Profit First strategy for getting yourself and your business out from under crushing debt is to allocate at least 95% of your profit toward debt until it is eliminated. That means, each quarter when it's time to take your quarterly profit distribution, you'll need to use at least 95% of what is in your **Profit Hold** account to pay off debt. Take the other 5% and do something fun. It may only get you dinner at Applebee's, but remember, the goal is to destroy your debt. There will be plenty of time to take bigger profits later, once you're out of debt.

Commit to a Debt Freeze

Before you go any further, it's important to understand how you got yourself into this situation to begin with. I have heard over and over that "business debt is good" and have come to believe that that's just not the case. Sure, we need to invest in our practices and sometimes that involves leveraging debt to acquire real estate, remodel our office, invest in technology, etc., but the problem is, most doctor owners simply overspend. It's too easy to go to a trade show and think you need to invest in the latest and greatest technology every year. But every investment that requires you to borrow money needs to be very carefully considered. It's important to understand how this additional debt is going to affect your efficiency and productivity relative to the impact it's going to have on your cash flow.

For instance, if you purchased one new piece of technology every year for 5 years consecutively and financed each one over 5 years (even at 0% interest…don't fall for it), by the fifth year, you will have 5 payments. And since most technology has a 5-year life spam (or less!), that means you'll be investing in new technology in year 5 to replace that first instrument you purchased in year one. If left unchecked, this cycle will never end. So unless this technology is driving profit in your practice, and I mean *really* driving it, it's nothing but a drain on your cash flow and peace of mind.

So, if you want to get out of debt, you'll need to commit to a ***debt freeze***. That means no more debt. Period. You can't get out of debt by continuing to spend. You must slam on the brakes now and commit to stop spending until you can get a handle on your debt. The beauty is, once you're out of debt, you'll have the cash flow to invest in the things you need to be more profitable, efficient and productive, most likely without even having to borrow a penny.

Dave Ramsey's Debt Snowball Strategy

Radio host and financial advisor Dave Ramsey suggests an excellent strategy for eliminating your debt. First, make a list of all your debt starting with the lowest balances to the highest. Aggressively put every single extra penny you have to pay off this first debt. Continue making the minimum monthly payments on the other debts. It's important to not worry about interest rates at this time. Just pick the one with the lowest balance and start there. We'll need a quick "win", in this case, paying off some debt, even a small one.

Once that first debt is paid off, apply those proceeds plus the minimum payment you've been making, and anything else you can afford to apply to it, to the debt with the second lowest balance until this is paid off. Continue this strategy until all of your debt is paid off. It's called the "debt snowball" because once you get a few debts paid off, an increasingly larger payment will be made to the debts with the higher balances, and these will go quickly.

List Your Business Debt

In the table below, make a list of all of your business debt including bank loans, bank notes, practice debt, equipment loans, lines of credit, credit card debt, money borrowed from family, etc. beginning with the debt with the lowest principal balance due and ending with the debt with the highest principal balance. Don't worry about the amount of the monthly payment or the interest rates. Simply list them in order of increasing balance due.

Name of Debt	Balance Due (lowest to highest)	Monthly Payment
TOTAL DEBT		

Once you've listed all of your debt, continue making the minimum monthly payments to all of your debt until you have paid off the first loan with the lowest balance. In addition, apply at least 95% of your profit from your **Profit** account each quarter to this debt until it is fully paid. Now use the money that you had been paying on this first debt and apply it to the second debt, in addition to the minimum payment. Continue applying at least 95% of the **Profit** account each quarter to this debt until it is fully paid. As you make progress paying down your debt, you'll have larger and larger amounts of money available, creating a snowball effect, rapidly destroying your debt.

Step 8 – Eradicating Your Expenses

As you begin to increase your CAP% each quarter to your **Profit, Owner's Comp** and **Tax** accounts, you'll need to decrease your **Op Exp** account spending accordingly. For instance, if you increase your **Profit, Owner's Comp** and **Tax** account each by 1%, you'll need to decrease your **Op Exp** account contribution by 3%.

Reducing your operating expenses requires some hard work, discipline and commitment to running your business more profitably. You can achieve this by taking a hard look at every penny you spend to run your business. When you look closely, you will most likely find some surprises: unnecessary expenses, wasteful spending, or overpaying for things that could be renegotiated for a better price.

Loss Aversion

If you were given the choice between a $1,000,000 practice with a profit of $300,000 and a $1,000,000 practice with a profit of $150,000, it's fairly obvious which practice you would choose. The rational choice is the practice that makes the most amount of money, right? Unfortunately, humans aren't always rational. In fact, when it comes to money, we are highly irrational in many cases. Money is not just a tool used to purchase the goods and services we need, but rather a highly emotional part of our lives. Every decision we make about money creates some kind of emotional response whether that be the joy of purchasing a new car or the frustration of the repair bills when that same car breaks down.

In behavioral psychology, **loss aversion** refers to the tendency to prefer not to lose something over gaining that same object. In fact, we place greater value on what we have over what we don't, even when they are of the same value. Losing $100 often feels twice as bad as the satisfaction we get from gaining $100. We will work twice as hard not to lose our homes to foreclosure as we would to purchase another home of the same value.

Psychologists theorize that loss aversion is biologically hardwired in us for our survival. For us to survive as a species, it is much more important that we avoid *losing* today's food than it is to *gain* tomorrow's food. Our focus is on what we have, and how we can keep it, even if what we are holding onto is irrational or unnecessary.

So, what does all this have to do with our practices? As it turns, we are not immune from irrational behavior in our practices too. In fact, many of the decisions we make about how we spend our money is not made from a rational point of view, but rather from an emotional connection to something we want to buy, or how we may see ourselves once we've made the purchase. When we purchase a $50,000 piece of new technology, we see ourselves as providing exceptional patient care, in a practice on the leading edge of technology, and experiencing the personal satisfaction of providing that care to our patients. These are all excellent reasons for making the purchase, however, we often forget to consider the financial impact that this might have on practices.

So now it's time to start the hard work of cutting expenses, and this is when that pesky biology gets in the way. The completely rational thing to do is to completely cut out all unnecessary expenses and replace or renegotiate any critical expenses in our practices. Yet something is holding us back. We hang onto those expenses and the status quo as if our life depended on it. We are avoiding loss even though rationally every penny that we cut will land in our own pocket. After all, isn't that the whole point? Aren't we in business to make money, and as much as possible, not just to provide for ourselves and our families, but also to provide a fair wage for our team members?

Our reluctance lies in our aversion to: 1) admit to ourselves that we made a bad decision to make the purchase in the first place (**I feel** dumb); 2) I've already made the investment, can't recover the costs, and don't want to lose what I've invested (sunk costs); 3) what if later we might need it and can no longer get it **(fear);** 4) confronting our vendors (who may be our friends) and telling them we no longer want or need what they are offering (**afraid** of what they might think about me and my business); 5) the **fear** of hurting our own businesses (what if cutting the expense hurts revenue?)

These are all perfectly good (i.e., emotional) reasons to hold on to unnecessary expenses, but not very rational, or very smart. Cutting expenses in our practices begins with recognizing the emotional origin of every decision we make about money. Once we've acknowledged to ourselves that this is just a feeling, and not a rational or wise business decision, we can begin the methodical (and rational) task of eradicating our expenses and improving our bottom line and pocketbook.

Getting Busy Cutting Expenses

Start by making a list of all of your expenses for the last year. You can find this information on your Profit and Loss Statement or from your accountant. Next to each expense, place a **P** next to everything that directly results in a profit. Place an **R** by everything that could be renegotiated for a better price or replaced by another vendor that could save you money. And finally, place a **U** by all expenses that are unnecessary to running a profitable business.

Start with the low hanging fruit first. Most likely, you'll have a few expenses with a **U** next to them. Cut these expenses out immediately. For example, start with what I call "But's it's only…" expenses such as subscriptions for Pandora, Spotify, Netflix, Audible.com, On Hold music services, gym memberships that you no longer use, credit cards with expensive annual fees, etc. You'll be tempted to hang on to these expenses and tell yourself…"but it's only $20 a month". The problem is, these expenses add up. Next thing you know, you'll be saving a couple hundred dollars a month ($1,000-$2,000 per year!) on things that really aren't necessary to running your business.

Once you've taken care of the easy stuff, contact all of your vendors that you placed an **R** next to and see if you can negotiate a better price. Also, see if you can find alternative vendors that can provide the same services for less money. You will most likely find that your current vendors will work with you, especially if you are willing to walk away for a better price.

Finally, take a careful look at all of your expenses that have a **P** next to them. Here, you'll want to be careful not to cut too much, assuming they are, in fact, directly resulting in a profit. For instance, it is not recommended that you try to renegotiate your staff salaries. If, after taking a hard look at your staffing you've determined that you are heavy on payroll, it's better to lay someone off rather than cut your employee’s pay. This can be demoralizing and result in a negative culture, which may hurt sales.

List Your Expenses

This will take some time, but you might discover hundreds, if not thousands, of dollars of savings by looking at every single expense you have in your business. Start by pulling out your Profit and Loss Statement for a full year and make a list of all of your expenses. It’s best to list them by actual vendor if possible. If you use accounting software such as QuickBooks, this is easily achieved by running your P&L Statement and drilling down on every expense listed.

Once you’ve made a list of all your vendor expenses, place a check mark in the appropriate column next to the expense with **P** representing an expense that directly results in a **profit** in your business (such as your staff), a **R** next to any expense that can be renegotiated or replaced with a less expensive vendor (such as frame vendors), and a **U** next to every expense that is unnecessary to running a profitable practice.

Expense	P	R	U

Now go back, starting with everything with a **U** next to it and eliminate it immediately. Just pick up the phone or get on the internet and cancel it! You'll be surprised how liberating this will feel because every dollar in expenses you save equals a dollar in profit, to you!

Next, contact each vendor with a **R** next to it and tell them that you would like to renegotiate their fees. Be prepared that you may need to move your business to another vendor if they are unwilling to budge. Chances are, if you've been a good customer, they will most likely work with you. If not, move on.

Finally, take a hard look at each of the expenses checked with a **P**. Make sure these expenses are actually directly resulting in a profit in your practice. You don't want to cut expenses that are driving revenue, so just be careful with cutting too much. The goal here is not to make so many cuts that you hurt your business, but rather to be as lean as possible.

5 Profit First Expense Cutting Strategies:

Strategy #1: Always look for a free option. There are often many products and services that can be replaced with a free version. Sure, you might give up a few benefits and features when comparing the free version to a paid version, but chances are, you may likely get what you need with the added expense.

Strategy #2: Never buy new when you can get the same benefit by buying used. High priced technology is often built to last. A 3-year-old car, for instance, can last for years. Let the original owner (that paid full price!) experience all of the depreciation of the technology. You can often get good quality used equipment and technology for half the price of new.

Strategy #3: Never pay full price if you can avoid it. Everything is negotiable. Simply asking, "before I do some price shopping, is that your best price?" can often result in significant savings. If you don't ask, they won't offer.

Strategy #4: Look for lower cost alternatives. Just about every product or service has competition. And competition means alternatives. Whether it be a competing company or just plain ingenuity, there are numerous ways to accomplish most objectives with a little thought, effort and creativity.

Strategy #5: Delay major purchases until you have considered all other options. It's surprising how often delaying a purchase often results in a realization that you never really needed that product or service in the first place. By delaying purchases, we allow the situation to "breathe". By doing so, problems and solutions often work themselves out without requiring us to make a substantial investment. Before making the investment, write down 5 alternatives to making the purchase and think through each one carefully.

Create a Victory Grid

Now that you've made some hard cuts to your business expenses, it's time to celebrate a bit and bask in the glow of how much money you'll be saving. In the table below, make a list of all of the expenses that you have either eliminated completely or renegotiated for a better price and total it up. Just look how much you were able to save simply by committing to eradicating your expenses!

Expense	Annual Savings
TOTAL ANNUAL SAVINGS	

Bonus Material – How Much Can (And Should) I Pay Myself?

As a business coach, I frequently analyze practices to help answer the all-to-common question: "Where's all the money?" During this process, I often find that the doctor-owner is either taking too much or too little in owner's pay. In other words, the owner is either taking too little out of the practice in owner's compensation, in most cases because there's not enough cash available to pay a reasonable wage, or they are taking out too much, starving the business of much needed capital.

Another common practice I see is using the business bank account as a personal ATM machine, withdrawing funds whenever needed, or whenever cash is available, to meet personal lifestyle needs. Sometimes referred to as "bank balance accounting", that is, making financial decisions based on your bank account balance, either for business or personal reasons, can lead to serious financial consequences including poor cash flow, inaccurate financial statements and a potential IRS audit, not to mention more than a few sleepless nights. But knowing just how much you should be paying yourself can be a difficult task.

Important Considerations

Assuming you own the business, there are two considerations when determining your own pay. The first is, "how much *can* I pay myself?" Just like any other expense in your business, your own personal compensation needs to fit within the framework of the economics of your business. Overpaying yourself creates the same cash flow problems as overspending on frames, rent or overpaid staff.

The second is, "how much *should* I pay myself?" If you are an S-corporation, for instance, regardless of what you think you are worth, the IRS has its own opinion of how much you should be paid as an investor-employee of your own company.

How much *can* I pay myself?

It's tempting to withdraw money from your business account whenever you need it, especially when it's available. However, without a clear understanding of how much your business can afford, you are almost guaranteed to find yourself in a cash flow crisis before long.

Determining how much your practice can afford to pay you depends largely on three key factors: 1) the size of your practice; 2) how well your expenses are controlled; and 3) the amount of debt you have.

The size of your practice largely determines how much you can afford to pay yourself both as an employee and investor in your business. Obviously, a practice that produces $3,000,000 annually would likely be able to afford to pay its owner more than one generating $800,000. But not always!

Equally important is how well you manage your expenses, in particular, your cost of goods sold (COGS) and people costs since these often make up as much as half or more of your company's expenses. It's possible that a well-run $800,000 practice could outperform a $1,000,000 practice if expenses are managed properly, resulting in more resources available to pay the owner.

And finally, the amount of debt you have makes a significant impact on what's left over to pay the owner. In fact, this is probably the biggest threat I see to owner's pay. It's easy to get caught up in investing in the latest technology, accumulating massive amounts of practice debt. Because this debt has to be repaid out of the profit of the business, burying your practice in debt will surely take a major bite out of your personal income.

To help understand what your business can afford to pay you, you must first get to know your cash flow. A good place to start is by looking at a one-year snapshot of your Profit and Loss statement. This will tell you what's left over after all expenses are paid, but before the doctors are paid (both owners and associates), and before the debt is repaid. This is sometimes referred to as the "Net Operating Income" (NOI).

Once you've determined your NOI, you'll then need to subtract your debt payments (both principal and interest), tax reserves and any capital reserves (i.e., emergency funds) planned to cover cash shortfalls on slow months or for unforeseen disasters. In theory, what's left over would be available to compensate the practice owner.

Here's an example of how an average size practice might determine how much it can afford to pay its owner:

INCOME (Annual)	$750,000
EXPENSES	
Cost of Goods Sold	$210,000
Staff Salary and Wages (Including Associate ODs)	$180,000
Occupancy	$60,000
Other Operating Expenses	$90,000
NET OPERATING INCOME	$210,000
Tax Reserves	$36,000
Debt Service (Principal + Interest)	$60,000
Capital Reserves	$18,000
Available for Owner's Compensation	$96,000

Calculate What Your Practice Can Afford To Pay You Here:

INCOME (Annual)	
EXPENSES	
Cost of Goods Sold	
Staff Salary and Wages (Including Associate ODs)	
Occupancy	
Other Operating Expenses	
NET OPERATING INCOME	
Associate Doctor Compensation	
Tax Reserves	
Debt Service (Principal + Interest)	
Capital Reserves	
Available for Owner's Compensation	

If after performing this exercise you don't like what you see, and feel you deserve more, you really only have three choices: 1) increase your practice revenue; 2) decrease your expenses, or 3) get rid of your debt. Your tax reserves should NEVER be neglected since this is, after all, not your money and belongs to Uncle Sam. You should also avoid prioritizing or padding your own compensation before considering your capital reserve targets. This is your safety net when there's a slow month (there will be slow months), an office flood, personal illness or a planned vacation. It's going to happen, so you need to be prepared. Only after you have met all of these obligations should you consider what's left to pay yourself.

How much ***should*** I pay myself?

Once you determine how much your business *can* pay you, the next question is how much *should* you be paid, and how?

Many practices elect S-Corporation status, which passes the profit and loss of the company through to the owner, to avoid self-employment tax. These include Social Security (old-age, survivors, disability insurance) and Medicare (hospital insurance) taxes that employers are required to pay for and on behalf of its employees. In 2019, the Social Security tax rate is 12.4% on the first $132,900 earned, and the Medicare rate is 2.9% with no cap on income. These taxes are split equally between the company and employee, which means the company is responsible for 6.2% of Social Security and 1.45% for Medicare.

Summary of Federal Taxes (2020)

Federal Taxes	Rate	Employer Pays	Employee Pays
Federal Withholding	Varies		X
Social Security	12.4%	X	X
Medicare	2.9%	X	X
Fed Unemployment (FUTA)	6%	X	

*Social Security - 50/50 split between employer and employee up to the first $137,700 earned (2020).

**Medicare – 50/50 split between employer and employee. No cap on income.

***FUTA – Up to the first $7,000 earned

However, if you own your company and are both the employer and employee, you would be responsible for the entire tax (15.3%). That means for every $100,000 of W-2 income you earn, your self-employment tax would be $15,300. By taking that same $100,00 as a distribution instead of a W-2 wage, you would avoid the tax liability altogether, and save yourself $15,300 in taxes. Because of this obvious advantage, it's very tempting for S-Corporation owners to take their compensation in the form of a company distribution rather than a W-2 salary. But not so fast! As you might imagine, this is a major red flag with the IRS. If it's determined that the owners are not taking their compensation appropriately in the form of W-2 income to avoid self-employment taxes, an audit could be looming.

Determining "Reasonable Compensation"

According to the IRS, S-Corporation owners must pay themselves a "reasonable compensation" if they are providing "meaningful service" to the business. If a doctor is actively seeing patients and managing the business, the IRS's expectation is that the doctor would be compensating herself appropriately as a W-2 employee.

IRS rules state that employee-owners must pay themselves a comparable wage to that of someone with similar training and experience performing the same job. For example, if Dr. Jones is seeing patients 3 days per week, spending 1 day performing administrative duties, spending a half day as the practice CEO, and taking a half day off for personal time, reasonable compensation could be calculated based on what it would cost to have an associate doctor in the practice 3 days per week, an office administrator 1 day per week, and a CEO one half day per week.

Example of Fair Market Compensation

Office Role	Days/Week	Daily Compensation	Weekly Compensation	Annual Compensation
Clinical OD	3	$500	$1500	$78,000
Practice CEO	0.5	$308	$154	$8,008
Practice Admin	1	$154	$154	$8,008
TOTAL				$94,016

Clinical OD based on $130,000 annual compensation
Practice CEO based on $80,000 annual compensation
Practice Administrator based on $40,000 annual compensation

Once you have satisfied the IRS's requirements for reasonable compensation by paying yourself a fair market W-2 wage, it would seem reasonable to take any additional profit as a distribution, which would avoid self-employment taxes. It is, of course, important that you consult your CPA or tax advisor since there may be other considerations that may affect this decision.

Calculate Your Own Fair Market Compensation Here:

FMV Calculator	Days/Week	Daily Comp	Weekly Comp	Annual Comp
Clinical OD	A1	B1	C1	D1
Owner/CEO	A2	B2	C2	D2
Owner/Admin	A3	B3	C3	D3
TOTAL COMP				D4

Clinical OD Compensation - This is the amount of compensation you receive for actually being the doctor (i.e., seeing patients). Take your annual revenue and divide it by 200,000. This will give you a rough estimate of the true clinical days you spend based on an efficient OD. (Assumes an efficient OD can generate $1,000,000 in collections per year.)

Owner/CEO Compensation - This is the amount of time you spend as the visionary of your practice, creating and directing the forward progress of your business from a high level. Most ODs spent less than one half day a week thinking about the big picture.

Owner/Admin Compensation - This is the amount of time you spend performing administrative tasks in your practice such as paying bills, managing staff, doing payroll, etc.

Instructions:

A1: Enter the total number of days you spend as a clinical OD
A2: Enter the total number of days you spend as practice CEO/Visionary of your business
A3: Enter the total number of days you spend performing administrative tasks such as paying bills, payroll, managing staff, etc.

B1: Enter the fair market daily rate for a clinical OD in your area
B2: Enter the fair market daily rate that a CEO might make managing a practice of your size
B3: Enter the fair market daily rate of an administrator that would perform the administrative duties in your practice

C1: Multiply A1 times B1 - this is the weekly compensation for Clinical OD
C2: Multiply A2 times B2 - this is the weekly compensation for OD/CEO
C3: Multiply A3 times B3 - this is the weekly compensation for OD/Admin

D1: Multiply C1 times 52 - This is the annual compensation for Clinical OD
D2: Multiply C2 times 52 - This is the annual compensation for OD/CEO
D3: Multiply C3 times 52 - This is the annual compensation for OD/Admin

D4: Total all values in the D column (D1 through D3). This is your total annual Fair Market Compensation, or your fair market W-2 wage as an employee of your business.

Determining a reasonable compensation for you as the owner is a critical part of operating a healthy practice. While overpaying yourself might make you feel more successful, you are likely draining your practice of necessary fuel it needs (cash!) to operate successfully and withstand the inevitable ups and down that you'll no doubt face. On the other hand, not paying yourself a reasonable W-2 wage, and using your business bank account as an ATM machine, could expose you to unwanted IRS interest in your practice. The best advice is consult with your tax specialist. They can give you the guidance you need, and help you find that number that's just right to both keep your practice healthy and viable, and you out of trouble with the IRS.

Conclusion

Now that you've seen, what I believe, is a better way to manage your business, I would recommend that you do two things. First, read *Profit First*. Presented here is a brief overview of the concepts from the book, which I have taken the liberty to modify (only slightly) for practice owners. To get the full benefit of the concepts (and humor) in Mike's book, take the time to sit down and read it. It's a very easy read. You may even find yourself having a hard time putting it down (I did)!

Second, I would recommend that you take a leap of faith and just implement the principles explained here, even if you don't fully have confidence that it will work for you. And don't be tempted to take shortcuts, create fewer accounts, try to manage this on a spreadsheet, etc. It just won't work! If you're really just not sure, then I encourage you to at least transfer 1% from your current account into a new account and call it "profit". And do this with every dollar you collect from now on. You might be surprised how good it feels.

You probably have, no doubt, a million reasons why you won't go back and implement this system, but if you do, I can almost guarantee that you will find that your business becomes immediately profitable. As an added bonus, you may also notice a decrease in the financial stress you've been feeling running your business. More money and less stress,….you can't beat that. It's your choice.