

## Top 20 Financial Related Questions

**PACIFIC VETERINARY  
CONFERENCE 2011  
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## Question # 1

Interest Rates – How to Choose Between  
Fixed and Variable



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### Question # 1 – Fixed v. Variable

- Fixed Rate – Where the interest rate on the loan remains the same throughout the term of the loan (5 years, 15 years, 30 years)
- Variable Rate – Where the interest rate on the loan periodically adjusts based on some index
  - Can adjust quarterly, annually, or over irregular periods.
  - Can adjust based on movement of Treasury Rate, Prime Rate, or other index. (Prime + 2.00%)



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### Question # 1 – Fixed v. Variable

- Home Loans
- Practice Loans
- Commercial Real Estate Loans
- Don't like surprises
- Remember: Rates today at all time lows



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### Question # 1 – Fixed v. Variable

- Example
  - \$300,000 loan
  - Ten year term
  - Fixed rate: 6.35% life of loan
  - Variable rate: 3.5% currently, adjusts annually
  - Assume rates increase 1% per year for next 6 years (Year 2 – 4.5%, Year 3 – 5.5%, etc. up to 9.50%)
  - Total interest paid – Fixed Loan: \$105,964
  - Total interest paid – Variable Loan: \$105,282



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## Question # 2

I'm looking at a new car. Should I lease it  
or buy it?



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### Question # 2 – Lease Car v. Buy Car

- Key Questions:
  - Are you a “flipper” or a “keeper”?
  - Flipper – Like a new car every three years
  - Keeper – Holds on to car for five or more years
  - How many miles do you drive a year?
  - Will you be using car for business? Write-offs?



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### Question # 2 – Lease Car v. Buy Car

- Other Key Questions:
  - Lease Terms?
  - Financing Terms?
  - Generally speaking, leases are cheaper to get in to.
  - Generally speaking, purchasing will cost you less in long run



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### Question # 2 – Lease Car v. Buy Car

- Example:



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### Question # 2 – Lease Car v. Buy Car

	<u>Lease</u>	<u>Buy</u>
Purchase Price	30,000	30,000
Down Payment	3,000	6,000
Effective Interest Rate	5.00%	5.00%
Monthly Payment (3 yr lease/loan)	\$ 476.00	\$ 719.00
Total Paid over 3 years	20,136	31,884
Value of Car Owned	0	(18,000)
<b>Net out of pocket – 3 Years</b>	<b>20,568</b>	<b>13,884</b>
<b>Net out of pocket – 5 years</b>	<b>28,200</b>	<b>18,180</b>

[www.edmunds.com](http://www.edmunds.com)



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### Question # 3

Should I keep my books on accrual basis or cash basis?



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### Question # 3 – Accrual v. Cash

- Cash Basis
  - Process of reporting revenues and expenses in the financial statements of the period when the cash is received or paid
  - Do not have a “matching” between when revenue generating activity occurs and when revenue recognized. Same with expenses.
  - Comparative financial statements less reliable



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### Question # 3 – Accrual v. Cash

- Accrual Basis
  - Process of recording revenues and expenses in the financial statements of the period in which the transaction occurs vs. when cash is received or paid
  - Revenue recognized when earned
  - Expenses recognized when incurred
  - Comparative financial statements more reliable



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### Question # 3 – Accrual v. Cash

- Modified Cash Basis
  - Primarily cash based
  - Some transactions handled on an accrual basis—inventory capitalization, fixed asset capitalization and depreciation
  - Accrual items usually determined by IRS requirements



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### Question # 3 – Accrual v. Cash

- Remember
  - Accrual basis is most accurate for analyzing practice results, and financial comparisons
  - Cash basis is less time consuming
  - Revenue of \$5,000,000 – accrual basis required by IRS



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### Question # 4

What are the most important Internal Controls for my practice?



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### Question # 4 – Internal Controls

Experience has revealed to us that small businesses run an inherently greater risk of employee theft because of their lack of checks and balances.



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### Question # 4 – Internal Controls

- A few important factors to remember about embezzlement and theft in small businesses:
  - If they occur, most thefts in your practice will only involve one person,
  - Generally, only the people you trust will be able to steal from you, and get away with it.
  - Most embezzlements continue for months before being discovered.



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#### Question # 4 – Internal Controls

- Division of responsibilities – cannot be overemphasized
- Bank Statements mailed to owner's home.
- Checks signed by owner only.
- Thumb through cancelled checks. Look at payee and endorsement.
- Watch for behavioral changes in employees
- Make deposits daily. Only bad things can happen otherwise
- Check references of employees
- Let everyone know that you're watching
- A small amount of due diligence can go a long way



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#### Question # 5

What are the 7 income tax religious holidays I should always remember?



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#### Question # 5 – Tax Religious Holidays

- March 15 – Corporate Tax Returns Due
- April 15 – Individual, Partnership, Trust Tax Returns due. Also, 1<sup>st</sup> Quarter estimates due for current year
- June 15 – 2<sup>nd</sup> Quarter estimates due for current year
- September 15 – Corporate, Partnership and trust tax returns due, if you filed extension. Also, 3<sup>rd</sup> quarter estimates due.



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#### Question # 5 – Tax Religious Holidays

- October 15 – Individual tax returns due, if you filed an extension.
- January 15 – 4<sup>th</sup> quarter estimates due for year just ended.
- And...



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#### Question # 5 – Tax Religious Holidays

- Three years from date you filed tax return, **AUDIT PERIOD CLOSED!!**
  - Example: filed your 2007 tax return on July 3, 2008, today that tax return's audit period closes.



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#### Question # 6

What is the difference between a tax deduction and a tax credit?



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### Question # 6 – Deduction v. Credit

- Tax Deduction – An amount that is allowed to reduce your taxable income, which is the base from which your income tax is calculated.
- Tax Credit – A dollar for dollar reduction in your income tax.



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### Question # 6 – Deduction v. Credit

- Example:
- \$1,000 deduction
- \$1,000 credit
- Which is more valuable?
- Deduction of \$1,000 x 40% tax rate = \$400 savings in tax
- Credit of \$1,000 = \$1,000 savings in tax



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### Question # 6 – Deduction v. Credit

- |   |  |
|---|--|
| <ul style="list-style-type: none"><li>• DEDUCTIONS<ul style="list-style-type: none"><li>– CHARITY</li><li>– PROPERTY TAXES</li><li>– MORTGAGE INTEREST</li><li>– MEDICAL EXPENSES</li><li>– STATE TAXES</li><li>– IRA CONTRIBUTION</li><li>– HSA CONTRIBUTION</li></ul></li></ul> | <ul style="list-style-type: none"><li>• CREDITS<ul style="list-style-type: none"><li>– FOREIGN TAXES PAID</li><li>– CHILD</li><li>– DAYCARE</li><li>– SOLAR</li><li>– RESEARCH</li></ul></li></ul> |
|---|--|



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### Question # 7

I have an old, beat-up used car. Should I sell it or donate it to charity?



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### Question # 7 – Donate or Sell Used Car?

- How much can you sell it for?
- How “much” could you donate it for?
- Sell for \$2,000, donate for \$2,000, assuming 40% tax bracket:
  - Selling gives you \$2,000
  - Donating gives you \$800
- Sell for \$2,000, donate for \$5,000:
  - Selling gives you \$2,000
  - Donating gives you \$2,000



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### Question # 7 – Donate or Sell Used Car?

Also Consider:

- Hassle Factor: time, energy, costs involved
- Feel Good Factor: afterglow of giving to good cause
- Risk Factor: selling a lemon, something goes wrong after the fact
- Kook Factor: Dealing with a certain segment of population



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## Question # 8

What is the difference between taxable income and cash flow?



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## Question # 8 – Taxable Income v Cash Flow

- Taxable Income:
  - Includes non-cash expenses like depreciation and amortization
  - Includes interest on loans
  - Excludes loan principal reduction (Balance Sheet)
  - Excludes equipment purchases (Balance Sheet)



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## Question # 8 – Taxable Income v Cash Flow

- Cash Flow:
  - Includes total loan payments (interest and principal)
  - Includes equipment purchases
  - Excludes non-cash expenses like depreciation and amortization



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## Question # 8 – Taxable Income v Cash Flow

	<u>Taxable Income</u>	<u>Cash Flow</u>
Revenue	1,000,000	1,000,000
Less:		
Cost of Prof. Services	240,000	240,000
Payroll	460,000	460,000
Occupancy	120,000	120,000
Administrative Expenses	60,000	60,000
Loan Interest Expense	45,000	-0-
Total Loan Payments	-0-	75,000
Depreciation Expense	24,000	-0-
Small Equipment Purchase	-0-	21,000
<b>Net</b>	<b>\$ 51,000</b>	<b>\$ 24,000</b>



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## Question # 9

Buyers and Sellers of a Veterinary Practice – How are each impacted by the asset allocation?



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## Question # 9 – Asset Allocation

- When veterinary practice changes hand, generally the value is broken down into different categories:
  - Drugs and Supplies
  - Accounts Receivable
  - Equipment/Furnishings/Fixtures
  - Covenant not to Compete
  - Goodwill
  - Patient Records



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### Question # 9 – Asset Allocation

- Each has different tax treatment for buyer and seller
- Seller: Ordinary income rates, capital gain tax rates
- Buyer: Write off over one year, five years, seven years, fifteen years
- Good for one side usually bad for other
- Tug of war



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### Question # 9 – Asset Allocation

#### Seller - Example 1

	<u>Price</u>	<u>Tax</u>
Drugs and Supplies	\$ 25,000	\$ 10,500
Equipment/F&F	\$ 50,000	\$ 21,000
CNTC	\$ 100,000	\$ 42,000
Goodwill	\$ 700,000	\$ 189,000
Patient Records	\$ 125,000	\$ 33,750
<b>Total</b>	<b>\$1,000,000</b>	<b>\$ 296,250</b>
<b>Tax Percentage</b>	<b>29.6%</b>	



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### Question # 9 – Asset Allocation

#### Seller - Example 2

	<u>Price</u>	<u>Tax</u>
Drugs and Supplies	\$ 75,000	\$ 31,500
Equipment/F&F	\$ 150,000	\$ 63,000
CNTC	\$ 250,000	\$ 105,000
Goodwill	\$ 325,000	\$ 87,750
Patient Records	\$ 200,000	\$ 54,000
<b>Total</b>	<b>\$1,000,000</b>	<b>\$ 341,250</b>
<b>Tax Percentage</b>	<b>34.1%</b>	



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### Question # 9 – Asset Allocation

#### Buyer - Example 1

	<u>Price</u>	<u>1<sup>st</sup> yr w/o</u>
Drugs and Supplies	\$ 25,000	\$ 25,000
Equipment/F&F	\$ 50,000	\$ 50,000
CNTC	\$ 100,000	\$ 6,667
Goodwill	\$ 700,000	\$ 46,667
Patient Records	\$ 125,000	\$ 8,333
<b>Total</b>	<b>\$1,000,000</b>	<b>\$ 136,667</b>



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### Question # 9 – Asset Allocation

#### Buyer - Example 2

	<u>Price</u>	<u>Tax</u>
Drugs and Supplies	\$ 75,000	\$ 75,000
Equipment/F&F	\$ 150,000	\$ 150,000
CNTC	\$ 250,000	\$ 16,667
Goodwill	\$ 325,000	\$ 21,667
Patient Records	\$ 200,000	\$ 13,333
<b>Total</b>	<b>\$1,000,000</b>	<b>\$ 276,667</b>



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### Question # 10

How do you determine a fair salary for an owner?



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### Question # 10 – Fair Owner Salary

- Considerations:
  - Keep IRS happy – Payroll Taxes
  - Fairness amongst owners of practice
  - Comparing to veterinary industry
  - Valuation purposes



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### Question # 10 – Fair Owner Salary

- Possible Determinations:
  - Pay yourself at least as much as associate in your practice
  - Pay yourself enough to clear social security tax threshold (\$106,800 for 2011)
  - Pay yourself based on production
  - Pay yourself market rate for area
  - Pay should not throw your business into a loss



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### Question # 11

What is Due Diligence and Why is it Important?



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### Question # 11 – Due Diligence

- Why do you need?
  - Buy house – have inspection done
  - Buy used car – take to mechanic
  - Buy veterinary practice – do your due diligence
  - Selling veterinary practice – do your due diligence on buyer



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### Question # 11 – Due Diligence

- What does it mean?
  - Investigating all aspects of the practice
    - Financial
    - Operational
    - Legal
    - Other
  - Not taking their word for it
  - Pentagon: trust but verify



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### Question # 11 – Due Diligence

- Areas to Focus on:
  - Revenue. Most important area. Many transactions are based on gross revenue of practice. Can be overstated.
  - Staff. Rates/Salaries paid to each employee, and last time raises were given. Benefits currently paid. Accrued vacation and sick pay due to each current employee from the seller.
  - Assets. Match larger pieces of equipment in practice to equipment list. Test for quality. Verify veterinary software and version in use.
  - Zoning.
  - Investigate buyer. Will this person succeed? How much do you have riding on this person? Will she/he mesh with current staff and clients? What is his/her business acumen



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## Question # 12

Should I buy a large piece of equipment or lease it?



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## Question # 12 – Buy or lease equipment

- Remember:
  - Buying and leasing can be very similar:
    - Capital Lease - \$1 buy out
    - Treated same for depreciation/179 expense purposes
    - Sales Tax
  - Comes down to terms:
    - Down Payment
    - Interest Rate
    - Term/Length
    - Buy Out amount (\$1 or 10%)
    - Other details – warranties, training, installation, etc.
  - Lease usually cheaper to get into, costs more in long run.



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## Question # 13

What is the Difference between Taxable Income and True Income?



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## Question # 13 – Taxable Income v. True Income

- Taxable Income
  - Trying to keep low as possible
  - Includes all expenses, including quasi-business
  - May include excessive depreciation/179
- True Income
  - Good to know for financing purposes
  - Valuation purposes
  - Make adjustments for perks, other non-cash items
  - Good in comparing to rest of industry



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## Question # 13 – Taxable Income v True Income

	<u>Taxable Income</u>	<u>True Income</u>
Revenue	1,000,000	1,000,000
Less:		
Cost of Prof. Services	210,000	210,000
Payroll	460,000	460,000
Occupancy	120,000	120,000
Administrative Expenses	50,000	50,000
Loan Interest Expense	15,000	-0-
Owner Perks	35,000	-0-
Depreciation Expense	6,000	24,000
179 Equipment Expense	30,000	-0-
<b>Net</b>	<b>\$ 74,000</b>	<b>\$ 136,000</b>



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## Question # 14

What management reports should I pay attention to?



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## Question # 14 – Management Reports

### Goals

- Have good handle on practice finances and issues
- Be efficient with time
  - Work-life balance
- Find management information “sweet spot”
  - Not too little
  - Not too much



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## Question # 14 – Management Reports

### Goals

- System of financial reports in place
  - Timely
  - Reliable
  - Automated as possible
- Paints the “picture”
- Use to make decisions
- Be sure to follow up



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## Question # 14 – Management Reports

### – Flash Report

- Summarize activity by day:
  - Daily Revenue
  - Daily Deposit
  - Daily A/R Balance
  - Daily Checking Account Balance
  - Client Visits
  - New Clients



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## Question # 14 – Management Reports

### – Monthly Financial Statements

- Profit and loss comparable to prior year
  - Show differences in \$ and %
- Profit and loss comparable to budget
  - Show difference in \$ and %
- Balance Sheet
- Statement of Cash Flows
- All important...all give you results



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## Question # 14 – Management Reports

### – Accounts Payable Aging

- Are you current with bills?
- What bills are coming due (property taxes, delayed drug bills)
- Should show
  - Current (under 30 days)
  - 31-60 days
  - 61-90 days
  - 91-120 days
  - Over 120 days...(hopefully not)
- What to do about lagging payables/cash flow problems



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## Question # 14 – Management Reports

### – Income Tax Analysis

- Estimated taxes for year are usually based on prior year income
- Compare expected quarterly profit to actual
- Determine whether estimated taxes or withholding need to be adjusted
- Important if income is up or down significantly

### – True Profitability Analysis

- What was your true profit, after you adjust for all owner perks/rent/compensation?
- Target: 15-20%
- Used for valuation



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## Question # 15

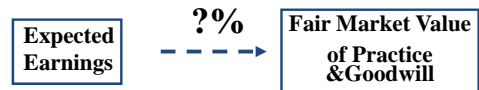
What exactly is a capitalization rate?



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## Question # 15 – Capitalization Rate

The process of converting  
the expected practice earnings  
to a fair market value



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## Question # 15 – Capitalization Rate

- What risk?
  - The risk the practice will not be able to continue generating the cash flow it currently does
  - Higher risk practice has higher rate and lower risk practice has lower rate
- Capitalization multiple (i.e. 5.0) is the inverse of the rate (1/20%)



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## Question # 15 – Capitalization Rate

- The level of return investors require before they will make the investment
- General theory is the same for different valuation methods, but multiple or rate representative of “best” practices will be different depending on the method



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## Question # 15 – Capitalization Rate

- Some appraisers use a constant cap rate (traditionally 5 in excess earnings valuations)
  - Why is this a problem?
- All practices with the same earnings are not equally desirable
- The desirability and risk associated with individual practices should be reflected in cap rate



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## Question # 15 – Capitalization Rate

What risk factors impact capitalization rate?

- Location
- Facility
- Demographics
- Veterinary competitive environment
- Practice stability
- Revenue/earnings growth



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### Question # 15 – Capitalization Rate

- Mix of services
- Effective practice transition
- Quality of staff
- Effectiveness of management systems
- Lease terms
- Non-compete covenants
- Marketability/desirability



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### Question #16

Why is a Feasibility Analysis Important to a Buyer and a Seller?



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### Question # 16 – Feasibility Analysis

- Buyer should expect earnings from the practice (salary and profits) to cover:
  - Repayment of debt incurred to purchase practice
  - Increased income taxes related to practice purchase
  - “Decent” living



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### Question # 16 – Feasibility Analysis

- Seller should expect proceeds/loan payments from the sale of the practice to cover:
  - Pay off all debts of practice
  - Cover taxes on Gain from Sale of Practice
  - Provide for expected cash flow needs post-ownership



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### Question # 16 – Feasibility Analysis

- Should be a part of the valuation process
- If so, buyer’s advisor should review for reasonableness and applicability to buyer’s situation
- If not, buyer’s advisor should prepare—this is the single most useful analysis the buyer’s advisor can do
- Advantages of this method
  - Uses sellers’ #s
  - Avoids complexities of valuation methodology



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### Question # 16 – Feasibility Analysis

- Use historical income statements from practice to estimate cash flow available to you as new practice owner
- See if this cash flow will cover the debt service, taxes and living costs under normal financing terms
- A reality check on the value derived for the practice by the appraiser—can the buyer make the deal work?



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### Question # 16 – Feasibility Analysis

	<u>No</u>	<u>Yes</u>
Net Cash Flow	\$ 350,000	\$ 350,000
Less: Owner Salary	( 150,000)	(150,000)
Less: Debt Service (\$2,000,000 purchase price, 15 years, 7.5%)	(222,480)	
Less: Debt Service (\$1,700,000 purchase price, 15 years, 7.5%)		(189,120)
Remaining Cash Flow	(\$ 22,480)	\$ 10,880



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### Question # 17

Should I pay my employees Semi-Monthly  
or Bi-Weekly?



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### Question # 17 – Semi-Monthly v. Bi-Weekly

- Semi-Monthly – Pay on 1<sup>st</sup> and 15<sup>th</sup> of every month
- Bi-Weekly – Pay every other Friday
- Semi-Monthly – 24 pay periods
- Bi-Weekly – 26 pay periods



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### Question # 17 – Semi-Monthly v. Bi-Weekly

- Semi-Monthly – Pay day floats. This period a Monday, next period a Wednesday.
- Bi-Weekly – Pay day stays consistent. Every other Friday.
- Semi-Monthly – Two payrolls every month.
- Bi-Weekly – Twice a year – the dreaded three payroll month...
- Consistency



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### Question # 18

I'm being audited! What should I do?



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### Question # 18 – Audit!!

- First...remain calm.
- What is it for?
  - IRS?
  - California?
  - Sales Tax?
- Make contact



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### Question # 18 – Audit!!

- Ask for change of venue
  - Force them to transfer case to different office where either you are located or CPA is located
  - Good chance it will
    - Get lost
    - Get postponed
    - New office will punt
- Shhhh. Trade secret. Amazing how often this works...



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### Question # 19

How do Rising Interest Rates Impact Practice Value?



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### Question # 19 – Rising Interest Rates

- Positively:
  - Rising rates usually mean growing economy. Practice should be healthier, bottom line better.
  - Savings/Money Market rates also increasing



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### Question # 19 – Rising Interest Rates

- Negatively:
  - Investors now require higher rate of return on investments. Higher rate of return means higher risk. Higher risk investments cost less. Veterinary practice would fall into this category.
  - Will cost buyer more to finance new practice. Higher rates mean less buyer can afford to spend on practice.



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### Question # 20

Who will win Wimbledon Final today?



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Questions?

