Dental practice accounting: **Why your cash flow statement is critical**

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"CASH IS KING." IF YOU'RE A DENTAL PRACTICE OWNER, THAT OLD CLICHÉ NEEDS REVISION. "Cash flow is king" is perhaps more appropriate. Why? While cash flow management is essential for any business, it's especially crucial for dental practices. With sky-high and ever-increasing overhead costs, one of the biggest threats to the long-term health of a dental business is a lack of cash.

In this second article of our dental practice accounting series, we'll help you become familiar with the cash flow statement so you can avoid harmful cash shortfalls. The cash flow statement is a financial statement that provides a summary of the movements of cash and cash equivalents in and out of your business. The cash flow statement measures how well a company manages its cash position, in other words, how well your practice uses generated revenue to fund its operating expenses and pay its current and long-term debt. Therefore, it's a critical measuring tool.

Many dentists prefer to focus on patient care and delegate cash management to a team member. We believe this is a dire mistake. Assigning critical and technical financial tasks can be an error regardless of how experienced and knowledgeable the staff member is about other aspects of the practice. The cash flow statement provides critical insight into the financial state of the practice and making informed decisions for your practice without it is impossible.

MEET THE CASH FLOW STATEMENT

In our last article, we discussed how financial statements help you assess and monitor the health of your practice so you can remain in control. Find it at dentaleconomics.com/financialstatements. The cash flow statement is often considered the most important of all financial statements, yet it's the most ignored and misunderstood. No matter how profitable your company is, you're not doing well if you're struggling to meet payroll or cannot cover your monthly expenses. While the cash flow statement often seems mysterious, once you become familiar with its nuances, it becomes easy to read and interpret.

WHY IS THIS FINANCIAL STATEMENT SO IMPORTANT?

The cash flow statement provides a rapid measurement of the health of your business. Specifically, it assesses your practice's ability to pay bills. One of the fundamental goals of business activity is to ensure cash is always ready to fund practice operations, meet your financial and payroll obligations, and pay for supplies, marketing, and other needs. Cash flow is a bloodline of the business that keeps it alive and growing. The cash flow statement is, in many ways, a diagnostic tool that provides you with a clear picture of the financial dynamics of your practice.

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The essential aspect of the cash flow statement is that it's designed to help you predict any cash shortfalls, so you have plenty of time to remedy the situation. By maintaining updated books and proactively reviewing your financial statements (particularly the cash flow statement) every month, you can keep ahead of cash crunches so you will always have time to prepare for financial shortfalls. Finally, the cash flow statement is a management report, and as such, it provides a time-saving way to assess your cash position quickly.

ILLUSTRATING THE IMPORTANCE OF CASH FLOW MANAGEMENT

Most of us in the dental profession experienced profound stress during COVID-19 in 2020. When dental appointments cratered or, in many cases, were prevented by lockdowns, cash became scarce. While this was due to an unexpected set of events no one could control, it provided a stark lesson in preparedness and maintaining emergency cash reserves. COVID-related events demonstrated how important financial management is for the dental business, and how vital cash flow is to the financial management process.

HOW TO READ YOUR CASH FLOW STATEMENT

What information are you looking for in your cash flow statement? Here's how you interpret what you'll find in the report. In the simplest terms, the report tells you what money is coming in and what money is going out. The statement has three main components that reflect day-to-day business activities: operating activities, which detail the cash flow from the business of delivering dental services; investing activities, which reflect cash flow from buying or selling assets for the business; and financial activities, which show the cash flow from any debt or equity financing in use. Each section provides a number that will be either positive or negative. By seeing these elements on paper, you can spot problems and have advance notice when you need to find options.

Positive cash flow is what you're seeking. Positive cash flow means that the company is taking in more cash than it's spending, which indicates the financial health of your enterprise. Conversely, negative cash flow indicates that the company is experiencing losses and requires attention. Negative cash flow reveals that the company is burning more money than it's collecting. While positive cash flow indicates that your bank account balance is increasing, negative cash flow implies the opposite and is a call for action.

If you see negative cash flow, make sure you have alternative sources of cash available to meet current obligations. Negative cash flow is troubling and comes with consequences, and you should learn how to mitigate it. Recognizing this dangerous trend in a timely manner is crucial.

THE DIFFERENCE BETWEEN CASH FLOW AND PROFIT AND LOSS (P&L) STATEMENTS?

The cash flow statement is not a P&L statement. While several elements of the cash flow statement represent the practice's financial obligations, such as practice financing payments, they do not correspond to the expenses that are reflected in the P&L statements. Only the interest portion of the total practice financing payment is reflected in the expense portion of the P&L statement.

In other words, while positive cash flow is a good thing, it doesn't always guarantee positive profits. Occasionally, positive cash flow can coexist with negative profits. This is usually caused by accounting entries such as depreciation (a noncash entry), capitalized costs, or one-time charges, which can reduce your profit. However, this type of situation is a good thing. In these scenarios, your cash flow stays high while your profit lowers your taxable income, reducing your tax liability. This example perfectly illustrates the difference between the cash flow statement and the P&L statement.

IS THIS A SHORT-TERM OR LONG-TERM ISSUE?

In reviewing your cash flow statement, focus on individual elements of the statement and assess whether these are short-term or long-term issues. While short-term issues tend to be operational, long-term problems tend to be structural.

For example, if you experience short-term cash crunches but your business is profitable, then a more significant reserve account may be all you need. However, if you frequently dip into negative cash flow, you may need to take a closer look at your expenses and find ways to reduce them.

WHAT DOES MY CASH FLOW STATEMENT WARN ME ABOUT?

As you become more familiar with reviewing your cash flow statement, you'll see that it can give you valuable messages about your business. Is cash flow positive? The message there, generally, is that you're doing things well, so continue what you're doing or look to implement your growth plans. But what happens in the all-too-common situation where you've got negative cash flow forecasted? Again, the key is seeing it on the report first so that you've got time to be proactive.

GENERAL STRATEGIES TO GET OUT OF THE RED

Create a reserve. Holding a reserve account is an ideal buffer to help smooth your cash flow. If you still experience occasional negative cash flow months, you may want to increase your reserves by earmarking a small percentage of earnings going forward. Remember, cash reserves are crucial and need to be built over time.

Improve billing and collections. Your cash flow statement will reflect when patients don't pay on time. Now is the time to look at your billing and collections processes. Can you bill faster to decrease the overall payment cycle? If invoices are being printed and mailed, consider switching to email invoicing and electronic payment options. What is the follow-up process for overdue amounts? Prioritize finding better solutions for these to improve cash flow.

Consider third-party credit options. If payment is a problem for clients, you may want to offer a third-party payment financing solution. This step can be a win/win to increase your practice's cash flow and make needed dental care more accessible for your patients.

Secure a line of credit with your bank. Sometimes you need cash to pay your bills on time. A dedicated line of credit can be a good option for this. The key is to use it with discipline. Keep in mind that compounding your debt makes it more difficult to pay and will make your cash flow statement more frightening.

The bottom line? While the P&L statement can be equated to a report card, the cash flow statement is more like a progress report. Don't ignore it like many business owners tend to do. Instead, heed the messages of this dynamic financial statement to help you with short- and long-term planning.

When used properly, your financial statements give you control and visibility. Instead of flying blind, you can make decisions confidently and have the peace of mind to distribute profits or reinvest in your business with more assurance. A cash flow statement can be easily generated by any accounting software. **DE**

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