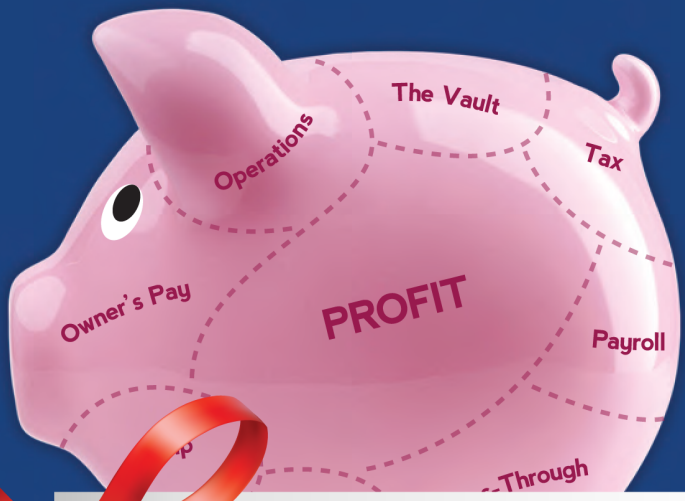
FIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROF

PROFIT FIRST

A SIMPLE SYSTEM TO TRANSFORM ANY BUSINESS FROM A CASH-EATING MONSTER TO A MONEY-MAKING MACHINE



ENJOY THIS GIFT FROM:

Tina Forsyth

www.TinaForsyth.com

CEO Business School

MIKE

Author of

FIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROFITFIRSTPROF

PRAISE FOR MIKE MICHALOWICZ

THE PUMPKIN PLAN

"Michalowicz is rapidly becoming one of the most innovative business authors of our time."

Rieva Lesonsky, former editorial director for *Entrepreneur Magazine*

"Every page, every chapter, as I read this book, I asked myself 'Michael E. Gerber, how come YOU didn't think of that?' Just remarkable. Just absolutely a remarkable book. Every one of you—entrepreneurs, business owners, read it! Do it now!"

Michael Gerber, author of *The E-Myth*

"This book reveals degrees of knowledge and wisdom I have rarely seen in writing before. If you read only one book this year, let it be *The Pumpkin Plan*."

Bob Burg, co-author of *The Go-Giver*

THE TOILET PAPER ENTREPRENEUR

"the business cult classic"

BusinessWeek

"[Mike Michalowicz is] knowledgeable. He's practical. He's brilliantly, refreshingly funny."

SmallBizTrends.com

"... if you need a swift kick in the butt to achieve your business dreams, read on."

BrazenCareerist.com

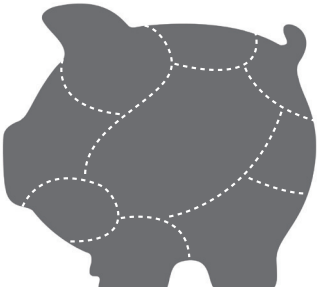
"I can say without hesitation that *The Toilet Paper Entrepreneur*, by Mike Michalowicz is the first book my Mom ever ran off with before I even had a chance to browse it."

Chris Brogan, social media expert and author of *The Impact Equation*

PROFIT FIRST

PROFIT FIRST

A SIMPLE SYSTEM TO TRANSFORM ANY BUSINESS FROM A CASH-EATING MONSTER TO A MONEY-MAKING MACHINE



MIKE MICHALOWICZ

Publisher: Obsidian Press
Print Management: Book Lab
Cover & Table Design: Liz Dobrinska
Book Design & Typesetting: Chinook Design, Inc.

2 3 4 5 6 7 8 9 10

© 2014 by Mike Michalowicz
All rights reserved. Published 2014

ISBN-10: 0981808298
ISBN-13: 978-0981808291

Printed in the United States of America

Disclaimer:
No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without the prior written permission of the publisher, Obsidian Press.

Limit of Liability/Disclaimer of Warranty:
This book contains the opinions and ideas of its author. It is sold with the understanding that neither the author nor the publisher, through the publication of this book, is engaged in rendering financial, legal, consulting, investment or other professional advice or services. If the reader requires such advice or services, a competent professional should be consulted. The strategies outlined in this book may not be suitable for every individual, and are not guaranteed or warranted to produce any particular results. No warranty is made with respect to the accuracy or completeness of the information contained herein. Both the author and publisher specifically disclaim any responsibility for any liability, loss, or risk, personal or otherwise, which is incurred as a consequence, directly or indirectly, of the use and application of any of the contents of this book.

CONTENTS

ACKNOWLEDGMENTS xi

INTRODUCTION 1

CHAPTER ONE
Taming the Beast 15

CHAPTER TWO
How Profit First Works 31

CHAPTER THREE
The Naked Truth 41

CHAPTER FOUR
Choose Your Own Adventure 57

CHAPTER FIVE
Day One, Quarter One, Year One and Forever 71

CHAPTER SIX
Destroying Debt 91

CHAPTER SEVEN
Found Money 115

CHAPTER EIGHT
Sticking With It 129

CHAPTER NINE
Profit First — Advanced Techniques 147

CHAPTER TEN
Living Profit First 165

CHAPTER ELEVEN
Where It All Falls Apart 181

CHAPTER TWELVE
Financial Freedom Is Just a Few Clicks Away 189

To my daughter, Adayla, and her piggy bank.

ACKNOWLEDGMENTS

They say it takes a small army to write a book. They're right. My army is Anjanette Harper.

Anjanette and I challenged each other relentlessly. We laughed. We cried. We yelled. We decided to give up, because it just couldn't be done. But finally it worked—we agreed on a small Mexican place for lunch and that the best thing to do was to share the nachos with the guacamole on the side. With that settled, we got to work on this book. Two years later we finished *Profit First*.

Thank you, Anjanette. You are the yin to my yin (yang is kinda overrated).

Thanks to Zoë Bird (who on earth knew a hyphen, en dash and em dash were different things? I take that back—you did), Nicki Harper (did you really proofread this in a barn?), Olaf Nelson (the eyeless black pig wins), Liz Dobrinska (seriously?!? Did someone just chase us down in a giant factory because your heel broke off at the welding station, thirty minutes ago, and you said nothing?), Jackie Pennetta (for booking every flight, hotel, rental car, taxi, and shipment—with never a single hiccup), Lisa DiMona (for saying "make them regret it"), and Melanie Ramiro (for helping me share everything I know, with everyone possible, on every single day available).

There was another elite force operating behind the scenes—similar to the Navy SEALS, but tougher. I called them the Fab 15. They volunteered to read Profit First the second I finished the manuscript and had eight days to read the entire book and give me critical feedback on every single concept in it. This elite team included: Debbie Horovitch (Social Sparkle & Shine), Gloria Rand (Internet Marketing Expert), Joey Himelfarb (client advocate and service

provider... in other words a really, really great salesperson), Kim LaCroix (The Inspired Vacation Journal), Paula Mottshaw (Freelance Creative), Lisa Robin Young (singer and musician), Bill Walsh (father of Liam, Cecile, and Nicholas), Frank Bravata (New Millennium Technology Services), Jeff Johnson (Technology Marketing Toolkit), Jessica Oman (Write Ahead Consulting), Nicole Fende (The Numbers Whisperer), Edwin Soler (Libreria Berea), Hilary Snow (My Massage Bliss), Jason Spencer (Spencer Weddings and Entertainment) and, perhaps the most integral, kind, genuine human being on this planet, Zarik Boghossian. If you are ever in the LA area, look Zarik up. Try to grab him for a cup of coffee and some *nazook*—you will discover the secret to being a shrewd entrepreneur and the most considerate, kindhearted soul at the same time.

Thank you to all the wonderful folks at creativeLIVE. This book wouldn't exist if wasn't for you.

To my children. . . It's time for a trip to Busch Gardens (that's our Disney). To Krista, I live you.

And my thank yous would not be complete without acknowledging you. My hat's off to you, entrepreneur. You are my definition of a superhero, you know, because you are fighting to bring profitability to yourself, your family, your employees, your community and our world. Thank you for that. Keep fighting, superhero!

INTRODUCTION

Profit First = mind blown. Everything I learned about accounting is now out the door #pumpkinLIVE @MikeMichalowicz @creativeLIVE
—Kali Ann Bauer @AmbientArtPhoto

This book was born in San Francisco. I was at the creativeLIVE studios teaching business growth strategies from my second book, *The Pumpkin Plan*. During one of the event sessions, I explained the basic concept of the Profit First system, the simple method I developed to ensure that I would have not only a financially healthy business, but a seriously *profitable* one.

One of the tools of Profit First is the Instant Assessment, a way to quickly gauge the real financial health of your business. When I ran the assessment on a volunteer attendee, the Profit First system clicked for everyone in the room.

All creativeLIVE presentations are also broadcast live online and eight thousand viewers had tuned in for my event. Tweets and comments started flying in from all over the world. Because the Instant Assessment is so fast and easy, I wasn't totally surprised to see the many comments from online viewers saying that they had assessed their business right then and there. Entrepreneurs, CEOs, freelancers, business owners—everyone shared how relieved they were to learn this simple method. It was as though they had each experienced a sudden, total clarity, an instant jolt of confidence about the money side of their businesses.

I had shared the four core principles of Profit First and the Instant Assessment in less than thirty minutes and I saw that people didn't just understand it, they were already applying it. When a tweet came

from Kali Ann Bauer @AmbientArtPhoto, I knew the Profit First system hit home. (Kali has since taken down her Twitter account, but you can check her out at AmbientArtPhotographynd.com.) Here is the tweet, captured by the creativeLIVE host:

Profit First = mind blown. Everything I learned about accounting is now out the door #pumpkinLIVE @MikeMichalowicz @creativeLIVE

But it wasn't until I met Debbie Horovitch that I understood just how vital it was that I break down the Profit First system further and make it available to entrepreneurs all over the world.

After the segment ended, we took a break. The camera and lighting people hustled to get ready for the next segment. Me? I was pumped! It was amazing to see this instant evidence showing how powerful Profit First truly is. Not only did it work for different people with different businesses of different sizes, it worked instantly. I was thrilled.

When the producer ran toward me, I threw up my hand for a high-five, but she didn't see it and went in for a fist bump instead. Then ensued the most awkward moment in human enthusiasm: when a high-five is met with a fist bump and quickly turns into a fist-five-handshake. So awkward. But she didn't even notice.

With her fist in my hand, she blurted, "That was amazing! Comments are still flying in. Can I use Profit First for my personal life? Be sure to open the next segment with a recap. Drink some water; your voice is getting a little hoarse. Take a quick five and then head over to makeup to get some shine off your forehead. And you can let go of my fist now, Mike."

The producer ran over to the lighting guys; I grabbed a glass of water, chewed on my pen and looked around to see if anyone had witnessed the fist-five.

That's when Debbie Horovitch, the entrepreneur behind the Social, Sparkle & Shine Agency—a Toronto, California firm that specializes in social media services—approached me. Debbie said, "Could we put my business through the assessment?"

"Sure," I said. "It only takes a minute or two."

Pen in my mouth, people hustling and bustling all around us, I ran through it right then and there. It was as if Debbie and I were in a world of our own. I scrawled her annual revenue number on the board. We ran the percentages. Debbie looked at the results and started to shake with sobs.

She couldn't bear to look at where she was, or where the Instant Assessment said she should be.

"I've been a fool," she said, tears streaming down her face. "Everything I have done over the last ten years is wrong. I am such a fool. I am a fool. I am a fool."

Let me admit right now, I'm a co-crier—when people cry I go right there with them. As soon as Debbie started, my eyes welled up with tears and the pen in my mouth dropped to the floor. I put my arm around Debbie to try to comfort her.

For ten years, Debbie had put her soul into her business, giving it everything she had, sacrificing her personal life in order to give her business life, and yet she didn't have a dime (or a successful business) to show for it. Of course she knew the truth of her struggles all along, but she had chosen to dance around that truth and continue to live in denial.

Putting your nose to the grindstone is a really easy way to cover up for an unhealthy business. We think, if we can just work harder, longer, better—if we can just *hold out*—something good will happen, one day. Something big is just around the corner, right? Something that can wipe away all of the debt, financial stress and worry, just like magic. After all, don't we deserve that? Isn't that how the story is supposed to end?

No, my friend, that's the movies —nothing like what we experience in real life.

When Debbie ran the Instant Assessment, she had to face reality: Her business was on the verge of death and it was taking her down with it. She kept saying, "I am a fool; I am a fool."

Those words tore into me, because I'd been there. I understand exactly how it feels to face the naked truth about my business, my bank account, my strategies and my hard-fought success.

My own wake-up call came in the form of my daughter's piggy bank. My story goes back before that, though, back to when I began to lose my way—the day I received a check for $388,000. It was the first of several checks I would receive for the sale of my second company, a multimillion-dollar computer forensic investigations business I had co-founded, to a Fortune 500 firm. I had now built and sold two companies, and that check was all the proof I needed that my friends and family were right about me: When it came to growing businesses, I had the Midas touch.

The day I received the check, I bought three cars: a Dodge Viper (my college fantasy dream car, something I promised I would get for myself "one day" when I "made it," aka, the "that-guy-must-have-a-tiny-penis-car"), a Land Rover for my wife, and a spare—a tricked-out BMW.

I had always believed in frugality, but now I was rich (with an ego to match). I joined the private club; the one where, the more money you give, the higher they place your name on the members' wall. And I rented a house on a remote Hawaiian island so my wife, my children and I could spend the next three or so weeks experiencing what our new lifestyle would be like. You know, "how the other half lives."

I thought it was time to revel in the money I had created. What I didn't know was, I was about to learn the difference between making money (income) and accumulating money (wealth). These are two very, *very* different things.

I launched my first business on ambition and air, sleeping in my car or under conference room tables when visiting clients in order to avoid the cost of hotels. So imagine the surprised look from my wife, Krista, when I asked the sales guy at the dealership for "the most expensive Land Rover you have." Not the best Land Rover. Not the safest Land Rover. The *most expensive* Land Rover. He skipped his way to the manager, doing a giddy hand-clap.

Krista looked at me and said, "Have you lost your mind? Can we really afford this?"

Full of snark, I said, "Can we afford it? We have more money than God." I will never forget the stupidity coming out of my mouth that

day; such disgusting words, such a disgusting ego. Krista was right. I had lost my mind—and, at least for the moment, my soul.

Yup. That day was the beginning of the end. What I was well on my way to discovering was, while I knew how to *make* millions, what I was really, really proficient at doing was *losing* millions.

It wasn't just the lifestyle I bought into that caused my financial downfall. The trappings of success were a symptom of my arrogance—I believed in my own mythology. I was King Midas, reinvented. I could do no wrong. And because I had the golden touch and knew how to build successful businesses, I decided that investing in a dozen brand-new start-ups was the best way to use my windfall. After all, it was only a matter of time before my entrepreneurial genius rubbed off on these promising companies.

Did I care if the founders of these companies knew what they were doing? No—I had all the answers (read that with massive douchey emphasis). I assumed that my golden touch would more than compensate for their lack of business expertise. I hired a team to manage the infrastructure of all of these start-ups—accounting, marketing, social media, web design. I was sure I had the formula for success: a promising start-up, the infrastructure and my incredible, superior, magic touch (more douchey emphasis).

Then, I started writing checks—five thousand to one person, ten thousand to another, every month more checks, and still more. One time, I cut a check for fifty thousand dollars to cover expenses for one of these companies. In retrospect, it was clear that I would not be able to grow all of these companies to the point where they would eventually become niche authorities, as I had with my two previous companies. There was never enough revenue to cover the ever-increasing mountain of bills.

Because of my massive ego, I didn't allow the good people who started these businesses to *become* true entrepreneurs. They were just my pawns. I ignored the signs and kept funneling money into my investments, sure that King Midas would be able to turn it all around.

Within twelve months, all of the companies I invested in, save for one, went belly-up. When I started writing checks to pay bills for

companies that had already folded, I realized that I was not an angel investor; I was the Angel of Death.

It was a monumental disaster. Scratch that; *I* was a monumental disaster. Within a couple of years, I lost nearly every penny of my hard-earned fortune. Over half a million in savings gone. A much larger (embarrassingly larger) amount of investment money gone. Worse, I had no incoming revenue. By February 14th of 2008, I was down to my last ten thousand dollars.

I will never forget that Valentine's Day. Not because it was so full of love (even though it was), but because it was the day I realized that the old adage, "When you hit rock bottom, the only way to go is up," is total bullshit. I discovered that day that, when you hit rock bottom, sometimes you get *dragged* along the bottom, scraping your face on every one of those rocks until you're battered, bruised and bloodied.

That morning, I got a call at my office from Keith, my accountant. He said, "Good news, Mike. I got a jump-start on your taxes this year and just finished your return for 2007. You only owe $28,000."

I felt a sharp pain in my chest, like a knife stabbing me. I remember thinking, "Is this what it feels like to have a heart attack?"

I would have to scramble to get the $18,000 I didn't have, and then figure out how to cover my mortgage next month plus all of the small recurring and unexpected expenses that added up to a whole lot of cash.

As Keith wrapped up the call, he said that the bill for his services would arrive on Monday.

"How much?" I asked.

"Two thousand."

I felt the knife twist. I had $10,000 to my name and bills totaling three times that amount. After I ended the call, I put my head on my desk and cried. I had gone so far astray from my values, from who I was at my core, that I had destroyed everything. Now, not only could I not pay my taxes; I had no idea how I would provide for my family.

At the Michalowicz household, Valentine's Day is a legit holiday—on a level with Thanksgiving. We have a special dinner together, exchange cards and go around the table sharing stories about what we

love about each other. This is why Valentine's Day is my favorite day of the year. Typically, I would come home with flowers, or balloons, or both. That Valentine's Day I came home with nothing.

Though I tried to hide it, my family knew something was wrong. At the dinner table, Krista asked me if I was okay. That was all it took for the dam to break. The shame was too great. I went from offering up forced smiles to sobbing in a matter of seconds. My children stared at me, shocked and horrified. When I finally stopped crying enough to speak, I said, "I lost everything. Every single penny."

Total. Silence. I slumped over in my chair; the shame was too great for me to face my family, not when all the money I had earned to support them was gone. Not only had I failed to provide for my family; my ego had stolen it all away. To this day I can find no other words to describe it: I felt pure, unadulterated shame about what I had done.

My daughter, Adayla, who was nine years old at the time, got up from the table and ran to her bedroom. I couldn't really blame her—I wanted to run away, too.

The silence continued for two painfully awkward minutes until Adayla walked back into the room carrying her piggy bank, the one she had received as a gift when she was born. It had clearly been cared for; even with all those years of use, there wasn't a single chip or crack on the bank. She had secured the rubber stopper in place with a combination of masking tape, duct tape and rubber bands.

Adayla set her piggy bank down on the dining room table and slid it toward me. Then she said the words that will stay with me until the day I die:

"Daddy, we're going to make it."

That Valentine's Day I woke up feeling like Debbie Horovitch felt after her Instant Assessment: like a fool. But by the end of the day I learned what net worth really is, thanks to my nine-year-old daughter. That day I also learned that no amount of talent, or ingenuity, or passion or skill would change the fact that cash is *still* king. I learned that a nine-year-old girl had mastered the essence of financial security: save your money and block access to it so it doesn't get stolen—by *you*. And I learned that I could tell myself that my natural aptitude for

business, my relentless drive and my solid work ethic could overcome any cash crisis, but it would be a lie.

Running the Instant Assessment can be like having a bucket of ice water dropped on your head. Or it can seem like the most humbling moment of your life, like when your daughter volunteers her life savings to save you from the mess you made. But no matter how sharp the pain is, it's better to face it than continue to live and operate your business in denial.

At creativeLIVE, after Debbie calmed down a bit, I said, "The last ten years were not wasted. I understand you feel that way right now, but it's not true. You needed to experience those years to get you where you are today, here with me, doing this. You needed to reach a point where enough is enough." To finally change, she needed her piggy bank moment. We all do.

The truth is, Debbie is far from a fool. Fools never seek out answers. Fools never realize there is a different way, even if it's staring them right in the face. Fools don't admit they need to change. Debbie faced the music, realized what she was doing wasn't working and decided she would not stand for it anymore. Debbie is smart and courageous, and a hero, too. She implored me to put her story in this book and not cloak her name… for you. Debbie wanted you to know you're not alone.

The majority of small businesses, and medium businesses, and even some big ones are barely surviving. That guy driving the new Tesla, whose children go to private school via chauffeur and who lives in a massive house and runs a three million-dollar company, is one bad month from declaring bankruptcy. I should know; he's my neighbor.

The entrepreneur who says "business is great" at the networking event is the same woman who later tries to ask me a question in the parking lot that is indecipherable through her tears; she's crying because she hasn't been able to pay herself a salary for almost a year and will soon be evicted from her home. That particular incident happened last night, twelve hours before I wrote it down to become a story for this book. It's just one of many similar conversations I've

had with entrepreneurs who are afraid to tell the truth about their financials.

The Young Entrepreneur of the Year Award recipient who is changing the world, who is lauded as the next generation of genius, who is destined to be on the cover of *Fortune* Magazine because of his business acumen, is taking out bank loan after bank loan and racking up credit card debt to cover payroll behind the scenes. I should know; that was me.

There is no elephant in the room. This dirty little secret is bigger than an elephant—it's King Kong, people! King Kong is in the room. And today is the day we call it what is. Today is the day we draw a line in the sand and never accept it again. Today is the day we make your business (and your life, in the process) financially strong. Permanently.

I have done it for myself. I have done it with companies I partnered with. And I have taught countless others how to do this and watched gleefully as their businesses turned the corner toward profitability.

I promise you, with everything I am, if you follow the system I detail in these pages, this book will do the same for you. The process is simple. Shockingly simple, once you know the trick. Sticking to it is the hard part. So I am going to give you both—how to do it *and* how to stick with it.

You have probably put a lot of work into growing your business. You are probably good or great at that part. That's awesome. And that's surely half of the equation. But colossal growth without financial health will still kill your company. A hot body is useless if its blood is poisoned; money is the lifeblood of your business. With this book, you have an opportunity to master money.

Money is the foundation. Without enough money, we cannot take our message, our products or our services to the world. Without enough money, we are slaves to the businesses we launched. I find this hilarious because, in large part, we started our businesses because we wanted to be free.

Without enough money, we cannot fully realize our authentic selves. Money amplifies who we are. There isn't a single ounce of doubt in my mind that you are intended to do something big on this planet.

You wear the cape of what I believe is the greatest of all superheroes: The Entrepreneur. But your superhero powers can only yield as much power as your energy source provides. Money. You need money, superhero.

When I sat down to evaluate where I went wrong I realized that, while my own spending and arrogance definitely played a part, I also lacked knowledge. I had mastered how to grow businesses quickly, yet I never really graduated to understanding profitability. I had learned how to collect money, for sure, but I had never learned how to keep it, how to control it or how to grow it.

I knew how to grow a business from nothing, working with whatever resources I had; but as revenue increased, so did my spending. I discovered that this was the way I ran both my personal life and my business. I took pride in making magic happen with pennies in my pocket, but as soon as I got some real cash, I made sure that I had a very good reason to spend it. It was a check-to-check lifestyle, but sustainable—as long as sales sustained and did not dip.

While my companies grew explosively, I still operated them on a check-to-check basis—and I had no idea that this was a problem. The point was to grow, right? Increase sales and the profit will take care of itself, right?

Wrong. Money problems occur when one of two things happen:

1. Sales slow down. The problem here is obvious—when we operate check-to-check and sales slow down, we don't have enough to cover expenses.

2. Sales speed up. This problem here is not obvious, but it is insidious. As our income climbs, expenses quickly follow. Consistent incoming cash flow is hard to sustain. Big deposits feel great, but are irregular. Drought periods come quickly and unexpectedly, causing a major gap in cash flow. And cutting back on expenses is nearly impossible because our business (and personal) lifestyle is locked in at our new level. Exchanging the newly leased car for a rust-bucket,

> laying off employees because we're overstaffed, saying no to our partners—all of this is very hard to do because of the agreements and promises we made. Cutting expenses becomes impossible because we don't want to admit we've been wrong in how we've been growing our businesses. So rather than reduce our costs in any meaningful way, we scramble to cover ridiculously high expenses. We steal from Peter to pay Paul, hoping for another big payout.

Sound familiar? I thought it might. Over the last five years I've connected with entrepreneurs at every level of growth, and this "top line" (revenue-focused), check-to-check methodology is more common than you may realize. We assume that multimillion-dollar companies are turning big profits, but it's rare to find a truly profitable business. Most entrepreneurs are just covering their monthly nut (or worse) and accumulating massive debt.

We think bigger is better, but so often all we get with a bigger business are *bigger problems*.

Without an understanding of profitability, every business, no matter how big, no matter how "successful," is a house of cards. I made a lot of money with my first two businesses, but not because I ran a tight fiscal ship. I was just lucky enough to keep the plates spinning fast enough and the company growing big enough that someone else was willing to buy it and fix the financial problems.

I sold my first two businesses for a big payout and so did not learn the ultimate financial lesson until after I invested in a dozen more businesses and the lesson came in hard. After my house of cards fell, I set out on a mission to find a better way, a simpler way, a highly effective way to ensure that all businesses, regardless of size and regardless of their current state of affairs, could end the check-to-check cycle and become instantly profitable—without chasing the big payout.

And I found it.

Simply put, the Profit First system flips the accounting formula. To date, entrepreneurs, CEOS, freelancers, everyone in nearly every type of business has been using the "sell, pay expenses, and see what's left

over" method of profit creation. This ingrained belief has us sell first, then pay expenses, and let the profit take care of itself. Which it rarely does, because the profit is what's *left over*. An afterthought. Profit surely isn't baked into the daily operations. For many entrepreneurs profit is only considered after the fact. Sometimes monthly. Sometimes quarterly. And way too often, annually, when their accountant is preparing the tax returns.

The old, been-around-forever, profitless formula is:

Sales – Expenses = Profit

The new, Profit First Formula is:

Sales – Profit = Expenses

The math in both formulas is the same. Logically, nothing has changed. But Profit First speaks to human behavior—it accounts for the regular Joes of the world, like me, who have a tendency to spend all of whatever is available to us. So in this regard, with the Profit First flip, *everything* has changed. Now you secure your profit *first,* and run your business on the remaining cash you have left.

It comes down to this—do you want to treat your profitability like leftovers, knowing you may only find scraps or an empty plate? Or do you want to get your full, healthy share right up front? I don't know about you, but I want to get my due portion first.

I have taught the Profit First system to small companies and big companies, to private companies and even public companies. It works for all of them. And it will work for you.

My commitment to you is that, if you follow the Profit First system, your business will become permanently profitable from the moment of your next deposit.

Since I began following the system, I have built two more businesses for myself that are now growing at a healthy rate, profitable right from the start. And the one business that managed to survive my Angel-of-Death spending spree? We implemented Profit First and that business

is now not only the leader of its niche; it also turns a profit every month.

In the pages of this book, you will discover how to make your business permanently profitable. The Profit First system is simple—as I said, shockingly so. But don't confuse simple with easy. Understanding what I am about to reveal to you will be a no-brainer. Having the discipline to do it and follow through will be the challenge. I will ready you for both.

Provided you take each action step I recommend, you will have transformed your business by the end of Chapter 5. Do I want you to read the rest of the book? Hell yes! In fact, if you want to fully realize your potential as a business leader and take your business where you *know* it was meant to go, you need to read the rest of the book. Consider Chapters 6 through 12 the intermediate and advanced courses in Profit First, in which you will learn all of the methods, tactics and tweaks that will ensure your cash cow continues to make your life easier, happier and more fulfilling. In essence, Chapters 1 through 5 will revive your business. Chapters 6 through 12 will revive *you*.

Following the Profit First system will take courage and dedication; it will require you to set your own ego aside. The payoff is worth it, so worth it.

If you will commit to fixing your business's financials once and for all, you'll never have to pull off a last-minute miracle to cover *anything* again. You'll never have to have your own "piggy bank" moment, as I did, or feel like a fool, as my friend Debbie did when she first realized the financial reality of her business.

When you commit to following the simple but powerful Profit First system, you will finally reap the rewards of entrepreneurship, cashing in on your business—while *still running it*—over and over again, like clockwork.

Today is the day you say enough is enough. Whether your business is experiencing occasional financial stress or total financial horror, today is the day we fix it. Today is the day your business becomes permanently profitable.

1 TAMING THE BEAST

I am Dr. Frankenstein.

Okay, not *the* Dr. Frankenstein, but I am definitely part of the family. I'm probably his long lost twin brother, or something. Or maybe an estranged heir to his (mis)fortune. Maybe you are, too.

If you read Mary Shelley's classic, *Frankenstein,* you know exactly what I'm talking about. The good doctor reanimated life. From mismatched body parts, he stitched together a living being more monster than man. Of course, his creation wasn't a monster at first. No, at first it was a miracle. Dr. Frankenstein brought to life something that, without his extraordinary idea and exhaustive hard work, would not exist.

That's what I did. That's what you did. We brought something to life that didn't exist before we dreamed it up; we created a business out of thin air. Impressive! Miraculous! Beautiful! Or at least it was, until the monster revealed itself.

Stitching together a business with nothing but a great idea, your unique talents and whatever few resources you have at hand is most certainly a miracle. And it feels like one, too. Until the day you realize your business has become a giant, scary, soul-sucking, cash-eating monster. That's the day you discover that you, too, are an esteemed member of the Frankenstein family.

And, just as happened in Shelley's book, mental and physical torment ensues. You try to tame the monster, but you can't. The monster wreaks destruction at every turn: empty bank accounts, credit card debt, loans and an ever-increasing list of "must-pay" expenses. He eats up your time, too. You wake up before sunrise to work, and you're still at it long after the sun goes down. You work

and work, yet the monster continues to loom. Your relentless work doesn't free you; it further drains you. Trying to keep the monster at bay before it destroys your entire world is exhausting. You suffer sleepless nights, worries about collection calls—sometimes from your own employees—and a near-constant panic about how to cover next week's bills with a few dollars and the lint in your pocket.

What is the only way out we can see? Growth. It is the battle cry of nearly every entrepreneur and business leader. Grow! Grow! Grow! Bigger sales. Bigger customers. Bigger investors.

The only problem is, it doesn't work.

Growth is only half the equation. It is a critical half, but still only half. Have you ever seen the guys at the gym with the massive arms and heaving chests, the ones as big as oxen who also have toothpick legs? They're only working half the equation and have become unhealthy freaks as a result. Sure, that guy can throw a monster punch, but God forbid he needs to step into it, or move a little. His puny legs will give out instantly; he'll curl up on the floor and cry like a baby.

Most business owners try to grow their way out of their problems, hinging salvation on the next big sale or customer or investor, but the result is simply a bigger monster. (And the bigger your company gets, the more anxiety you deal with. If both are cash-eating monsters, a $300,000 company is much easier to manage than a $3,000,000 company. I know; I have survived operating both, and bigger.) This is constant growth without concern for health. And the day that big sale or customer or investor doesn't show, *you* will fall to the ground and curl up crying like a baby.

If you think operating your business is closer to a horror story than to a fairy tale, you're not alone. Since I wrote my first book, *The Toilet Paper Entrepreneur,* I've met thousands of entrepreneurs; and let me tell you, most are struggling to tame the beast that is their business. Many companies—even those that appear to have it all together, even the big guys who seem to dominate their industries—struggle to stay afloat.

I'll never forget meeting the owner of a $15,000,000 company who furnished his house with plastic lawn furniture because he couldn't

afford the real stuff. What does it say when the leader of a multimillion-dollar company can't even swing a trip to Ikea? It would make anyone question his true wealth, and the wealth and health of his business.

So what's the solution? How do you not only make it out of this situation alive, but also build the miracle of a business you originally envisioned, a business that serves you, a business that provides *for* you? The solution isn't a bigger monster. The solution surely isn't a second and third monster. The solution isn't killing your existing monster, or even hacking it apart and stitching it back together into a tiny monster. In fact, the solution is shockingly simple and surprisingly effective.

It begins by working with your natural tendencies, not against them.

CHECK-TO-CHECK AND PANIC-TO-PANIC

Have you ever had the thought that the universe knows exactly how much extra money you have? A customer pays up on a $4000 past-due invoice you wrote off months ago and later that week your delivery truck breaks down—for good. Bye-bye, $4000. You land a new client and a wad of cash drops into your lap; only minutes later you remember that this is a three-payroll month. Oh well, at least now you'll almost be able to cover it. Or you get a credit on your credit card account for an accidental billing (woo hoo, found money!), only to discover another charge on your credit card for something that you forgot all about.

It's not the universe that knows how much we have in our bank accounts. It's us. We default to managing the cash of our business by doing what I call "bank balance accounting."

If you're like most entrepreneurs, and me, this is how it works:

You look at your bank balance and see a chunk of change. Yippee! You feel great for about ten minutes, and then decide to pay all the bills that have been piling up. The balance goes to zero and very quickly you feel that all-too-familiar tightening in the chest as your throat dries up (or any number of symptoms of stress).

What do we do when, instead of a decent bank balance, we see that there's next to nothing there? We immediately panic a little (or

a lot). We hit "go" mode: need to sell fast! Need to make collection calls! Need to pretend the bills never arrived, or send out checks and "accidentally" forget to sign them. When we know our bank balance is super low (I'm talking limbo "how low can you go"-low), we'll do anything to buy the only thing we can afford: time.

I'm going to go out on a limb and guess that you only look at your income statement on occasion. I suspect you rarely look at your cash flow statements or balance sheet. And if you do, I doubt you review these docs on a daily basis or understand exactly what they say. Bet you check your bank account every day, though? It's okay. If you look at your bank account daily, I want to congratulate you, because that means you are a typical—scratch that—a *normal* business leader; that's how most entrepreneurs behave.

It's human nature to look at what you have *right now* and make decisions based on that information. This is called the "Recency Effect," the psychological phenomenon in which we humans (that's you, by the way) place a disproportionate significance on what we experienced most recently. For example, if I ask you to recall the last few words I wrote, you will easily recall this sentence (the most recent), but good luck remembering two sentences ago.

Recent stuff is the big stuff; all the other stuff becomes a waning memory. How does the Recency Effect apply to your finances? If you deposit lots of money today, you will probably feel great, the outlook for your business will appear to be good and all will seem well. That's the Recency Effect. If, on the other hand, your bank account is bone dry, you might feel hopeless and your business may seem like a horrible mess. (Maybe as though it's a monster?) That's the Recency Effect. It is a trap because it dictates our behavior.

Also in our nature as entrepreneurs is the desire to find problems and fix them. This is how we manage money. When we have enough money in the bank, we think we don't have money problems, and so we focus on other challenges. When we see that we don't have enough money in the bank, we go on red alert and take immediate action to fix our money problems, usually by trying to collect revenue quickly, or sell a big-ticket item or some combination of the two.

We use the money we have to pay the bills we owe; when we don't have enough to cover everything, we try to get more money through sales and collections. Except that to support new revenue, we now have a host of new related expenses, so the cycle starts all over again. If you haven't relied on it from the start, eventually the only "solution" is to take on debt—a second mortgage on your family home, a line of credit tied to your building, a stack of credit cards three inches high. This is how many entrepreneurs end up operating their businesses check-to-check and panic-to-panic.

So let me ask you a question. How easy would it be to grow your business if you operated this way? Do you think you'd ever be able to get off this roller coaster ride? Could you dig yourself out of debt using this system? Of course not.

And yet bank balance accounting is human nature. We humans are not big on change. Change is hard. With your very best intentions, changing your natural tendencies to operate your business based on how much cash you see in your account would take years. I don't know, you tell me—do you have years to make your own transformation before your very own monster destroys everything? I sure as hell didn't.

This is why, if we are to free ourselves from living check-to-check and panic-to-panic, we must find a method that works *with* our nature, not against it.

Without an effective money management system that does not require massive mindset change, we get stuck in trying to sell our way out of our struggles. Sell more. Sell faster. Get money any way you can. It is trap—a dangerous trap that would even have Frankenstein's monster poopin' his panties. It's the Survival Trap.

THE SURVIVAL TRAP

This is how the Survival Trap works. Take a look at Figure 1 on the next page. We are at point A (which is really called crisis) and we want to get to point B (which is our vision for our future). The thing is, our vision is usually very vague. Instead of a clear statement of our products or services and the clients we want to serve, it might be

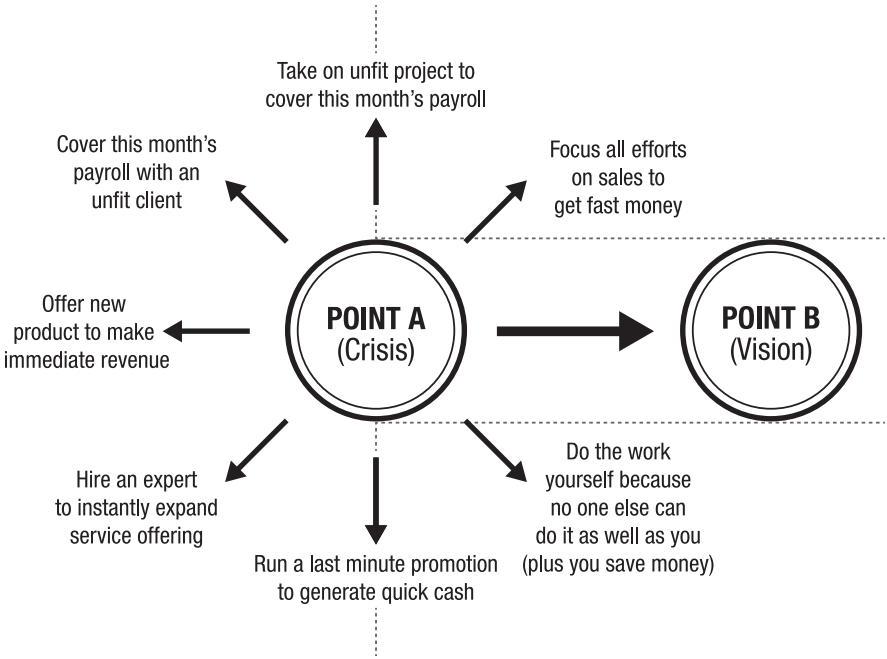


Figure 1: The Survival Trap

something like, "I want a lot of money and some relief from stress." The connection between Point A and Point B is never defined, beyond, "Sell, baby! Just sell!" And "just selling" is a huge part of the trap, for three reasons:

First, any sale feels like a good sale, because sales help to temporarily lift you out of crisis. Now look at the figure. You can see that many of the decisions we make around "just selling" in fact take us *farther away* from our vision.

Maybe you start offering a new service, or add a new product, because it will make fast money, but never even consider that it has nothing to do with what you want your company to become or whom you want your company to serve.

Take for example my lawn guy, Ernie. He, like most lawn guys in the Northeast, makes tons of money removing leaves. This past fall he knocked on my door and said that he noticed leaves in my gutters and would gladly clean them up. He has a captive client (me), and can now sell me another service. Easy money. When he was on the roof, he

noticed my shingles needed repair. He offered roofing services. Why not repair my chimney, too?

It is very easy to go from being a guy who rakes lawns to a guy who fixes chimneys because of the opportunity for "easy money" with captive clients. The money may be easy, but what about the costs to do it all? Rakes and blowers for yard work are useless when working on roofs or chimneys. Now this guy needs ladders, roofing gear, bricks and other materials. And most importantly, he needs the skills to complete the tasks, which means hiring skilled labor or going back to raking, gutter-cleaning, roofing and chimney school. Each new "easy sale" took Ernie farther from his vision for his lawn-raking business.

The Survival Trap promises fast wealth, but when we're caught in it we rarely think about the massive cost of opportunity; and most of the time, we can't discern profitable income from debt-generating income. Instead of being the world's best at one thing, mastering the process of delivering perfectly and super-efficiently, we end up doing a greater variety of things and become less and less efficient at each step, while our businesses become more and more costly to run.

The Survival Trap is not about driving toward our vision. It is all about taking action, any action, to get out of crisis. Any of the actions shown in Figure 1 will get a us out of an immediate crisis. But, by taking actions like those on the left of the circle, we get out of crisis, sure enough, but we are going in the opposite direction from our vision at Point B. Other actions shown on the diagram don't take us in the opposite direction, but are askew. Only when you stay in the channel of the horizontal dotted lines do you make your vision for your business a reality.

All of the "just sell" actions we take in the moment bring temporary relief. They get us out of immediate crisis, but when the money dries up again the following day, and as the expenses grow the following week or month, we find ourselves in crisis again and the pattern repeats. We take money from anyone (and I mean anyone) willing to pay us. Money from bad clients. Money for bad projects. Money from our own pockets (if there's anything left in them besides two dimes, a stick of gum and a wad of lint). In this way, we stay

stuck on the roller coaster ride that is surviving check-to-check and panic-to-panic.

Second, the Survival Trap is deceptive because it fools us into *thinking* we are at least inching toward our vision. Consider the actions on the right side of the Figure 1. For instance, a "just sell" approach will, by pure happenstance, also occasionally move us toward our vision, we can easily trick ourselves into believing that we're on the right track. Sometimes we make a crisis decision without considering our vision or the path to get there and we get it right. Happenstance happens. At that point we say, "See! I'm getting there. Things are clicking. Things are coming together." But this is random chance, resulting from crisis, not focus or clarity, and therefore false. It is like believing that because you once won on a scratch-off card, the lottery is a good investment strategy. And it is this kind of thinking that quickly lands us back in crisis mode.

Last, when we're stuck in the Survival Trap, we focus our attention on revenue generation first and foremost. Any client (who pays) is a good client. Any work (that makes money) is good work. Crisis makes us panic about money. We need more money now! Never forget: All revenue is *not* the same. Some revenue costs you significantly more in time and money; some costs you less. You must distinguish between the two, since one is profitable and the other puts you out of business.

I explained the Profit First system to my friend Debra Courtright many years back. Debra runs DAC Management, a bookkeeping business. (I'll give you one guess at her middle initial.) Since the day she integrated the Profit First system, Debra has saved company after company using these principles, the exact principles I am about to teach you. Actually, she has more than just saved companies; she consistently turns business after business into cash cows.

Over the years, we have discussed the effects of Profit First on her clients and made some tweaks along the way. She has shared many stories, always removing the names of the guilty. When Debra told me the story I am about to share with you, my jaw dropped. The story is about someone I've never met, about a business I've never visited, but it's a perfect example of the Survival Trap, played out.

Debra received an inquiry from Alex, a prospective client. When she called Debra, Alex was literally gasping for air on the other end of the line. The owner of a local bistro, Alex did not have enough money in the bank to pay her employees or vendors, let alone herself. Her accounting was so messed up she didn't even know to whom she owed money.

Debra immediately implemented a customized version of Profit First (something I will teach you to do for yourself in Chapter 4). While setting up a Profit Account, Owner's Pay Account, Tax Account and Operating Expenses Account, she asked Alex where she kept the sales tax records.

Alex looked at her blankly and said, "What do you mean?"

Turns out, Alex had been charging customers seven percent sales tax, but rather than reporting the earnings and sending the tax to the government, she was using the money to pay other bills.

Debra explained the consequences. "If you don't pay the taxes you collect, you are breaking the law. The state's tax authority can come in here unannounced, shut everything down and walk away with every asset you have. Then they will send you to jail, broke and in debt."

Alex thought she had time to sort everything out, but the very next week, Debra's warning became a reality. The tax reps from the state showed up unannounced at Alex's bistro.

They decided to show her mercy. In front of her customers and employees, they emptied the cash register and handed Alex a letter that basically said, "Pay your sales taxes immediately, or we will shut you down and send you to jail." Cue the next anxiety attack, and Alex's next breathless call to Debra. And yes, that is the tax man showing mercy.

The Survival Trap is an ugly beast. It buys you time, but the monster gets bigger and bigger. And at some point it will destroy you.

Sustained profitability depends on efficiency. You can't become efficient in crisis. In crisis, we justify making money at any cost, right now, even if it means skipping taxes or selling our souls. In crises, the Survival Trap becomes our modus operandi—until our survival strategies create a new, more devastating crisis that scares

us straight, as it did Alex, or, more commonly, scares us right out of business.

Part of the problem is bank balance accounting—looking at the money in your bank account as one pool from which you can operate your business without first addressing tax issues or your own salary, never mind profit. This leads to top line thinking—focusing on revenue first, last, and always. That thinking is supported by the traditional accounting method public companies must use and most small businesses elect to use: GAAP (Generally Accepted Accounting Principles).

GAAP IS KILLING YOUR BUSINESS

Since the dawn of time—or shortly thereafter—businesses have kept track of their earnings and expenditures using essentially the same method:

Sales – Expenses = Profit

If you manage the numbers like most entrepreneurs, you start with sales (the top line) and then subtract costs directly related to the delivery of your offering (product or service). Then you subtract all the other costs you incur to run your business: rent, utilities, office supplies and other administrative expenses, sales commissions, taking your client out to lunch, signage, insurance, etc., etc. Then you pay taxes. Then, and only then, do you take your owner's distribution (owner's salary, profit distribution, etc.).

Let's be honest, entrepreneurs hardly ever take anything close to a real salary, and good luck telling the government that you decided to skip taxes this year so that you could pay yourself. Finally, after all that, you post your company's profit. And if your experience is like the majority of entrepreneurs, you never get to "finally." When you're waiting for the leftovers, at best you'll get scraps.

This method ultimately became formalized in the early 1900s. The particulars are updated regularly, but the core system remains the same. Start with sales. Subtract direct costs (the costs you directly

incur to create and deliver your product or service). Pay employees. Subtract indirect costs. Pay taxes. Pay owners (owner distributions). Retain or distribute profit (the bottom line). Even if you outsource your bookkeeping or keep a shoebox of receipts under your bed, you know the basic idea.

Logically, GAAP makes complete sense. It suggests that we sell as much as we can, spend as little as we can and pocket the difference. But humans aren't logical. (One episode of *Bridezilla* pretty much proves that.) Just because GAAP makes logical sense doesn't mean it makes "human sense." GAAP both supersedes our natural behavior and makes us believe bigger is better. So we try to sell more. We try, and try, and try to sell our way to success. We do everything we can to make the top line (revenue) grow so that something, anything, will drip down to the bottom line. It becomes a relentless cycle of chasing after every shiny object disguised as opportunity (that's "little pumpkins" to my peeps—you know who you are).

Throughout this haphazard, often desperate, growth process, our expenses are lost in the wash—we just pay as we go. They're all necessary, right? Or at least we think so. Who knows? We're too busy hunting down sales and trying to deliver on all of our promises to worry about the impact of expenses!

We try to spend less without considering investments versus costs. We don't think about leveraging our spending to get way more mileage out of way less. We can't. The more variety of stuff we sell, the more our cost of doing businesses rises. We need to spend more to grow. They say it takes money to make money. But how come no one ever told us what that really translates to: It takes *more* money to make *less* money.

As our monster gets bigger, the need to feed the beast gets out of hand. Now we're faced with covering expenses for more employees, more stuff, more everything. The monster grows. And grows. And grows. Meanwhile, we're still dealing with the same problems, just bigger: more empty bank accounts, higher stacks of credit card bills, bigger loans and an ever-increasing list of "must-pay" expenses. Sound familiar, Dr. Frankenstein?

GAAP's fundamental flaw is, it goes against human nature. No matter how much income we generate, we will always find a way to spend it—all of it. And we have good reasons for all of our spending choices. Everything is justified. Everything is necessary. Soon enough, whatever money we had in the bank dwindles down to nothing as we struggle to cover every "necessary" expense. We get caught in the trap of sell-grow-spend, sell-grow-spend.

How do you think Debra's client Alex ended up in her predicament? Do you think she said, "It's a beautiful day today—I think I'll steal from the government"? Heck, no. She had convinced herself that she needed the sales tax income she collected *right now,* and when "later" came, she wasn't prepared to cover it.

A secondary flaw is this: GAAP teaches us to focus on sales and expenses first. Once again, it works against our human nature, which urges us to grow what we focus on. Remember the lesson of the Recency Effect; it plays out again with the focus on sales and expenses. There is a saying: "What gets measured, gets done." GAAP has us measure sales first (it is the top line, after all), and therefore we sell like mad while expenses are treated like a necessary evil to support—you guessed it—more sales. We spend all that we have, because we believe we must. And we use terms like "plowback" or "reinvest" to feel good about it. Profit? Your salary? Mere afterthoughts. *Leftovers.*

Another problem with GAAP is, it is overwhelmingly complex. You need to hire an accountant to get it right, and when you ask the accountant the details about GAAP, he is likely to get confused. The system changes and is up for interpretation. And we can play games with GAAP: Move some numbers around and post stuff in different spots and the numbers look different. Just ask Enron—they were able to post profits as they were going bankrupt. Yuck!

At the end of the day, the start of a new day, and every second in between, cash is all that counts. It is the lifeblood of your business. Do you have it or not? If you don't, you're in trouble, and if you do, you can sustain.

GAAP was never intended to only manage cash. It is a system for understanding all the elements of your business. It has three

key reports: the income statement, the cash flow statement and the balance sheet. There is no question that you need to understand these reports, since they will give you a holistic view of your company; they are powerful and highly useful tools. But the essence of GAAP (Sales - Expenses = Profit) is horribly flawed. It is a formula that builds monsters. It is the Frankenstein Formula.

To successfully run a profitable business, we need a super-simple system to manage our cash, one we can understand without help from an accountant, one that is designed for humans, not Spock.

We need a system that can instantly tell us the truth about the health of our businesses, one that we can look at and know instantly what we need to do to get healthy; a system that tells us what we can actually spend and what needs to be reserved; a system that doesn't require us to change, but automatically works with our natural behaviors.

Profit First is that system.

• • •

The ending of *Frankenstein* is not happy or nicey-nice. The monster destroys everything in Dr. Frankenstein's life—his wife, his family, his hope for the future—so he sets out to exact revenge and kill his creation. The hunt for the monster takes a toll on Dr. Frankenstein and he dies a wrecked man, the monster close behind him. *Frankenstein* is a scary parallel to the extremes of entrepreneurship. Monster businesses have killed marriages, torn apart families and, for some entrepreneurs, decimated any hope for the good life. That miracle of a business we created can end up causing untold suffering; when that happens, the hatred Dr. Frankenstein had for his monster is all too often the chief emotion entrepreneurs have toward their businesses.

But your story doesn't have to end that way. You can have your happily ever after. The good news is that, while your business may seem to be a monster controlling your life, it is also powerful. Whether your annual revenue is $50,000, $500,000, $5,000,000 or even $50,000,000, your business can become a profit-generating workhorse.

Never forget the power of your "monster"—you just have to understand how to direct and control it. When you learn this simple system, your business will no longer be a monster; it will become an obedient, pasture-loving cash cow. A damn strong one, at that.

It worked for Alex, the coffee-shop owner who neglected to pay her sales tax and paid the consequences. Working with Debra, her accountant, and applying Profit First, Alex has paid off all of her taxes and penalties. It took three years to recover, but now Alex is current with her taxes and is running a profitable business. She has fewer employees, but they are fantastic and run the place like clockwork. Business is humming, and freshly ground coffee is always brewing.

What I am about to share with you is going to make your business profitable immediately and determinately. I don't care what size business you have or how long you have been surviving check-to-check and panic-to-panic, month after month and year after year. You are about to be profitable. Forevermore. No more leftovers for you—it's time for you to eat first.

Here's the deal. There is only one way to fix your financials: by facing your financials. You can't ignore them. You can't let someone else take care of them. You need to take charge of the numbers. But there is good news—the process is really, really easy. In fact, you will fundamentally understand it, and implement it, within just a few more chapters.

ACTION STEPS

GET YOUR HEAD IN THE GAME

Step 1: Draw the line in the sand. Agree that, as of today, you are turning over a new leaf. Commit to yourself, and to me, that you will run a profitable business and make everything else secondary to that goal. Email me (my contact info is on my website, and I do read my own email) and decree that you are drawing a line in the sand. Today is the day your business becomes healthy. Permanently. Don't wait another second.

Step 2: Agree not to beat yourself up. I don't care what your business financials look like today. I don't care if your business is on the verge of going under, or if you just want to ramp up your profits even higher. Every business can be improved with Profit First. The only thing that will get in our way is if you bitch, moan and cry about the past. So that will not be permitted. I am granting you a clean slate. And you are promising me that you aren't going to complain about the past. Together, we are just going to get to work and fix it.

2 HOW PROFIT FIRST WORKS

It's funny how losing nearly all of your money can cause you to watch a lot of late-night network TV. What? Before you side-eye me, this was right after I lost all of my money to my own arrogance, so cable TV was the first thing to go. Insomnia brought about by anxiety does *not* equal better quality sleep, so that pretty much left me with two options: Stare at the ceiling or watch late-night network TV, courtesy of my twelve-dollar, indoor rabbit-ear antenna (yes, antennae still work and, even with the fancy modern digital signal, the reception still sucks).

Most infomercials pitch instant cures. Eat only grapefruit for ten weeks, and presto! You're thin. Drink this magic goo three times a day and before you know it you'll be able to bounce a quarter off your ripped abs! Wrap this electromagnetic thingamajig around your waist, electrocute yourself every five seconds, and you'll have a teeny-tiny waist in less than six weeks, all while never getting off the couch to clean the Doritos off your shirt!

One late night, I had had enough of the infomercials and turned on PBS to find, sure enough, a fitness guy talking about diets. (Was God trying to tell me something? I stopped working out for a little bit, but. . . jeez!)

The fitness expert explained to the studio audience that the quick fixes lauded by late-night infomercials didn't work (thank you!) and that they weren't sustainable. He said that what we really need are simple *lifestyle* fixes that do not require us to change our natural tendencies, changes that make an impact before we have a chance to screw it up with our unhealthy food choices. And his first fix suggestion? Smaller plates.

Now riveted, I watched as the man explained that our natural human behavior is to fill our plates with food and, because Mom said so, clean that plate right up by eating everything on it. I still don't get Mom's logic—there are children starving in Africa, so I need to get fat? But the "clean-your-plate club" was instilled in me and probably in you, too. The message is ingrained. Changing that habit for a day is a no-brainer. But changing it permanently? That's hard. Some would say it's nearly impossible. This is why so many people who diet gain the weight back, why people rarely follow through on New Year's resolutions past the end of January, and why it's so difficult to be disciplined with your spending.

As I continued to watch the program, the expert went on to say that rather than work to change our "eat everything on the plate" behavior we simply need to change the size of our plates. When we use smaller plates, we dish out smaller portions, thus eating fewer calories while continuing our natural human behavior of serving a full plate and eating all of what is served.

I sat straight up on the couch, my mind alert with this new revelation. The solution is not to try to change our ingrained habits, which is really hard to pull off and nearly impossible to sustain; but instead to change the structure around us and *leverage* those habits.

It was then that I realized: Every penny my company made was going onto one plate, and I was gobbling it all up, using every last scrap to operate my business. Every dollar that came in went into one account, my operating account, and I was "eating it all."

It hurts to admit this, but I was never good at money management. I thought I was, but looking back now, I realize how bad I was at managing money. I thought I was frugal in principle, or because I was a savvy entrepreneur. But in truth, I was frugal in my businesses because it was forced upon me.

When I started my first company, a computer network integrator (today it would be called a managed service provider), I had no money. I was able to sell, service, run my office—I could do all that stuff with practically no money because I didn't have any. As the business grew, I started to spend. The more I made, the more I spent,

and I believed that all expenditures were necessary. We needed better equipment, a better office (an unfinished basement is no place for a business). I brought on people to do the work so I could sell more. Every step forward in sales growth required an equal step up in my infrastructure, human resources, grade-A office space or whatever (all fancy terms for expenses).

After losing it all, I discovered that I work with whatever is put in front of me. Give me a hundred dollars and I will make it happen. Give me a hundred grand and I will make it happen. And while a hundred thousand-dollars made it easier to make it happen, it also made it way easier to make mistakes. Totally waste a few hundred dollars when you have a hundred thousand at your disposal, and you feel nothing. Totally waste a few hundred bucks, when you only have a few hundo to your name, and you feel that pain fast and hard.

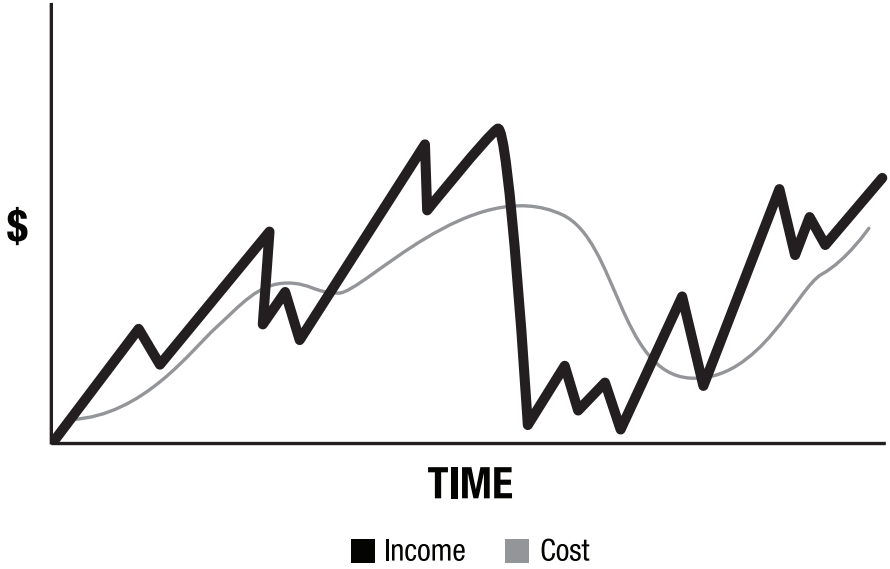


Figure 2: Income vs. Cost

Looking back at my companies, I realized that I grew them quickly but still survived check-to-check, only making the real money when I sold them. As my incoming cash increased (the darker line on Figure 2), my expenses increased at a similar rate (lighter line). The only time I would have a profit was when income jumped up and I didn't have

time to spend at the same rate. However, I would quickly ramp up my expenses to serve my "new level of sales." Then sales would settle back down, or drop, while my new level of expenses remained higher. Losses accumulated. The desperate need to sell more, faster, increased.

I muted the television and began to connect the dots. I wondered, "If I reduce the 'plate size' of my business's operating account, will I spend differently?" Looking back at my past behavior, the answer came quickly. Yes, I would. So rather than try to curb my spending habit, I would create the experience of having less cash on hand than I actually had. How did I know this would work? Because it already works for millions of people, with every paycheck—think 401K deductions.

Excited, I realized that, as with a 401K, if I were truly going to believe that the money I had left over in the bank after reducing my deposits from revenue (my small plate) was all I had to work with, whatever money I took off the top would have to go into a separate account that would not be easy for me to see, let alone access. Investment accounts charge penalties for early withdrawals to dissuade investors from drawing from their accounts, and I needed something similar in place to stop me from borrowing from the separate account.

But what would I *do* with the "other money?" Could I use it to—shock of shocks—*pay myself a salary?* Pay my taxes?

Hey. Hey wait. Wait one stinkin' minute. Could I actually set aside some of it for profit—*before* I paid bills?

And that's when it hit me—what if I took my profit *first?*

For a guy who built two businesses on top line (revenue focused) thinking, this was a revelation. At 3:00 a.m., it sounded like crazy talk. Who would have the audacity to take profit first?

Me.

WHAT THE DIET INDUSTRY KNOWS ABOUT GROWING A HEALTHY BUSINESS

A 2012 report by Koert Van Ittersum and Brian Wansink in the *Journal of Consumer Research* identifies the average plate size in America as having grown 23% between the years 1900 and 2012, from 9.6 inches

to 11.8 inches. Running the math, the article explains that, should this increase in plate size encourage an individual to consume just fifty more calories per day, that person would put on an extra five pounds of weight… each year. Year after year, that adds up to a very chunky monkey.

But using smaller plates is just one factor. A Twinkie on a small plate is still a Twinkie.

There is more to a healthy diet, based on four core principles of weight loss and nutrition. These four principles are exactly the same foundation for business health.

1. **Use Small Plates –** Using smaller plates starts a chain reaction. When you use a small plate, you get smaller portions, which means you take in fewer calories. When you take in fewer calories than you normally would, you start to lose weight.

2. **Serve Sequentially –** Eat the vegetables, rich in nutrients and vitamins, first. If you leave them to eat last, you will rarely finish your vegetables. They'll just sit there piled up on the side of the plate.

3. **Remove Temptation –** Remove any temptation from where you eat. People are driven by convenience. If when you're hungry, junk food is easily accessible, you're more likely to eat it. If you don't have any junk food in the house, you're probably not going to run out to the store to get it. (That would mean putting on pants.) You're going to eat the healthy food you stocked, instead. My weakness is Chocodiles: Twinkies covered in dark chocolate and wrapped in love. Fortunately, they stopped making them. But if one sneaked into my house, even if it had expired in 1972, I would devour that delicious elixir of love and monounsaturated fats. Now, I always make sure I have healthy options with me, and the junk is locked away.

4. **Enforce a Rhythm –** Don't eat when you're hungry; it is already too late, and you will binge. Instead, eat frequently so that you never get hungry. You will actually consume fewer calories this way.

Profit First is a simple, "small plate" diet philosophy. In the Introduction I shared the basic formula of Profit First and how it differs from the accounting method most businesses use.

The old profit-as-"leftovers" formula (what I like to call the Frankenstein Formula):

Sales – Expenses = Profit

The new Profit First Formula:

Sales – Profit = Expenses

What you are about to learn isn't anything new. It is something I suspect you have been aware of—in full or at least in part—but have never done. It is the concept of "pay yourself first" meets "small plate servings" meets "Grandma's hidden stash of money in the cookie jar" meets your pre-existing natural, human tendencies.

Here's how Profit First is like a successful diet:

1. **Use Small Plates –** When money comes into your main operating account, immediately disperse it into different accounts in predetermined percentages. Each of these accounts has a different objective: one is for profit, one for owner pay, another for taxes and another for operating expenses. These are the four basic accounts and where you should get started, but you will get more advanced in account setup as we move along.

2. **Serve Sequentially –** Always, *always* move money to your Profit Account first, then to your Owner Pay Account and then to your Tax Account, with what remains to expenses. Always in that order. No exceptions. Move it, stash it and let it accumulate. And if there isn't enough money left for expenses? This does *not* mean you need to pull from the other accounts. What it *does* mean is, you can't afford those expenses and need to get rid of them. This will bring more health to your business than you can ever imagine.

3. **Remove Temptation –** Move your Profit Account and other accounts out of arm's reach. Make it really hard and painful to get to that money, thereby removing the temptation to "borrow" (i.e., steal) from yourself. Use an accountability mechanism to prevent access, except for the right reason.

4. **Enforce A Rhythm –** Do your payables twice a month (specifically, on the 10th and 25th). Don't pay only when money is piled up in the account. Get into a rhythm of paying bills twice a month so you can see how cash accumulates and where the money really goes. This is controlled, recurring and frequent cash flow management, not by-the-seat-of-your-pants cash management.

When I started applying this small plate philosophy to my company's finances, I was doing consulting work and speaking on entrepreneurship. I also applied my new Profit First system to my one surviving investment, Hedgehog Leatherworks.

At the time, I was putting the finishing touches on my first business book, *The Toilet Paper Entrepreneur,* into which I inserted a small section about the concept of Profit First Accounting (PFA). After the book came out I continued to refine the system, exploring and living it, and everything changed. I started implementing it with other entrepreneurs. And it worked—for me, for them and for my readers. I started getting calls from people who had read the book and tried

basic PFA, creating amazing results. I also decided to drop the "A" from PFA—partly because Profit First is not an accounting system (it simply plugs into your accounting system) and partly because, when I heard Facebook used to be called "The Facebook" and dropped the "The" to sound cooler, I thought I would follow suit and drop a word.

Fueled by my passion for entrepreneurship and my determination to be profitable *now,* not at some indeterminate date in the future, I set about to perfect my system. In that process I discovered other entrepreneurs and business leaders who were running their businesses check-to-check and desperately needed the Profit First system. But I also found entrepreneurs and business leaders who had been implementing a similar system to great success. People like my barber, Lou Leone, the second-generation owner of a barbershop that has been profitable from day one. And Phil Tirone, who, while building his first, highly profitable multimillion-dollar business, continued to rent the same studio apartment until he determined that he had secured enough profit to upgrade—to a one bedroom.

In the coming pages, I will share these stories and more: stories about people who are in lockstep with their profits and stories about other folks, like you and me, who were giving it their all but still ended up only breaking even on their best days—people who now turn a profit every month and enjoy the fruits of their labors. People like Jose and Jorge, two entrepreneurs who started using Profit First from the first day they discovered it and have not only experienced very respectable growth, but have continuously taken in a 7% to 20% percent profit, month after month.

Your story isn't finished yet. Not in the least. It's time to create your happy, kickass chapter.

ACTION STEPS

GET YOUR BUSINESS PROFIT-READY

Step 1: Set up the small plates with your bank. You will need four accounts: Profit Account, Owner's Pay Account, Tax Account and Operating Expenses Account.

You probably already have one or two accounts with your bank (checking and savings). Keep the checking account as your Operating Expenses Account and set up Tax and Profit as savings accounts (these are simply holding bins), with Owner's Pay as another checking account.

Some banks limit the number of transfers in and out of savings accounts. This shouldn't be a problem, since we will be using a rhythm. However, if your Tax or Profit Accounts are checking accounts, that is fine. The goal is not to get a little extra interest; the goal is to hold money temporarily and remove temptation. Some banks charge fees or have minimum balance requirements. Don't let that deter you. Speak to the bank manager and negotiate the fees and requirements. If the manager is unwilling to negotiate, find a new bank.

Step 2: Set up two more external savings accounts with a bank other than the bank you use for daily operations. One account will be your no-temptation Profit Account. The second will be your no-temptation Tax Account. Set them up with the ability to withdraw money directly from the respective savings accounts in your original bank.

Step 3: Don't enable any of the "convenience" options for your two external accounts. You don't need or want to view these accounts online. You don't want checkbooks for these accounts. You just want to deposit your income and forget it… for now.

3 THE NAKED TRUTH

It's inevitable. Whenever two or more entrepreneurs are gathered together, one of them will ask the "How big is it?" question. It's always some version of the same—"How big is your business?" It might sound like, "How many employees do you have?" Or, "How many territories do you cover?" Or, if you're one of those straight-to-the-point types (like a few of my classmates at the high school reunion), you might even be so bold as to ask, "How much did you take in last year?" However it's phrased, I hear some version of the "How big is it?" question wherever I go—it's like a law of the entrepreneurial (and porn) community!

Many years ago, I joined a global entrepreneurial organization to learn from successful, more experienced business leaders from all over the country. At one of our meetings, I met my buddy Phil Tirone, founder of 720CreditScore.com. Phil made his first fortune in the mortgage lending industry in California, so he knows a thing or two about *real* wealth. Not the top line, or the outward appearance. The bottom line. The actual take home money. *The naked truth*.

"When you get a loan, you take down your pants. You can't hide anything," Phil told me as we enjoyed iced coffee outside his Phoenix home, staring at Camelback Mountain in the distance.

"There are things that people don't want to talk about. You don't want to talk about your lack of profit. You don't want to talk about putting a second mortgage on your home to help run your business. You surely don't want to admit to being the guy that has five times more credit card debt than the average family in our debtors' nation. After fourteen years of seeing entrepreneurs live lives that are a bunch of lies, I look at the concept of wealth with such a skeptical eye."

Phil went on to explain that, more than just hiding the truth of their financial situations, people aren't just kidding the world around them; they're kidding themselves. "I did a loan one time for a guy who had a car payment of forty-three hundred per month. He said to me, 'One day, when you're successful, you'll have a car payment like this.' I just smiled. This is what I'm supposed to aspire to? Everyone's perception of wealth is a joke."

It was with this skepticism that Phil walked into the first global entrepreneur meeting, and the second, and the third, hoping to connect with entrepreneurs who, like him, cared about the bottom line. As usual, all he heard was the same question over and over again. "How big is it?"

"All of the conversations were about revenue. Even the first conversation you and I had, Mike. It's bullshit. It's total bullshit," Phil said.

"Who cares about revenue? So you're running a twenty or fifty million-dollar company. You're living in a crap apartment, dude! You've got nothing in your accounts! The bank owns that car in the driveway. The credit card company owns your furniture. Your elderly parents paid for your vacation. Are you kidding me? What about profit? It makes no logical sense."

It's true. At our entrepreneur meetings there was little talk of profit, and many people in the room were counting on the sale of their businesses to finally cash in on their perceived success. When someone couldn't cover payroll that month, they would say they just needed one big project, or one new client, or an investor to swoop in. It's a common refrain among check-to-check entrepreneurs. One more big sale. One new client. Someone to just throw a lot of money at them.

These entrepreneurs were giving it everything they had to just survive, with one eye on the emergency exit sign.

I may not have been actively looking for an exit strategy while I ran my first two businesses, but it was the sale of those businesses that gave me actual wealth—and "permission" to act like an idiot. Would I have had the money to buy an expensive "stable" (yes, I used the

obnoxious term) of cars and invest in poorly planned start-ups if I hadn't sold my business? Nope. It doesn't matter how much money you have coming in, if you're only focused on growth, you aren't going to have much to show for your "big" business.

The exit strategy you're banking on? It rarely happens. My experience was the exception, partly due to my being in the right place at the right time. Buyers, investors, vendors and clients, too, are attracted to healthy businesses. Strong businesses. But that seems to be a rarity nowadays. Doesn't it?

Top line thinking (focusing on income) goes way beyond business. It's definitely part of American culture, this emphasis on size. Bigger is better. More, more, more. Grow! Grow! Grow! Heck, I even wrote a book about how to do it.

As I said in the introduction to *The Pumpkin Plan,* I stand by my method for growing niche-dominating businesses that lead to giant success. But we can't sustain that growth—or enjoy the fruits of our labors—if we keep putting profit at the bottom of our to-do list. Are you really going to keep struggling as you wait for that one big sale, that one big contract, that one big payoff that will erase all of your debt, get you back in the black and allow you to finally cut yourself a big fat check? It rarely happens and, when it does, the money seems to evaporate fast. It's a bit like asking Santa Claus for a million dollars, knowing full well that he's just a drunk guy in a red suit working at the mall (and for God's sake get off his lap).

I say we start a movement, right here and right now, to replace that tired old misguided question about size and replace it with this one: "How healthy is your business?" I'm serious—I can envision that question on t-shirts, hats, maybe someone (hint: you, not me) even tattooing a questionable area of his body with the slogan. Better yet, how about a blimp flying over Wall Street? That's how big a deal this is.

If you spend one more second worrying about the size of your business while compromising a strong bottom line, your business is unhealthy at best. More likely your business is dying a slow death. Big business is great, but only if there are healthy profits. Small is great

too, but only if there are healthy profits. Medium is great, but only if there are profits there, too. You get the picture, Goldilocks.

So, from this very second forward, ask only one question of yourself. Ask only one question of your entrepreneurial friends. Ask only one question of any business owner.

How *healthy* is your business?

Are you eating first, or are you surviving on leftovers, or worse—scraps from the garbage can in the alley?

By the end of this chapter, you'll answer that question; and whether your business is dying or just a little queasy, we are going to get it back to full health. I don't care how much your business is struggling financially, the fact that you are still in business means we can turn it around. Now, when people ask you how business is going, you will respond with, "Healthy. Things are very, very healthy!" And you won't be lying to them or yourself. You can even get naked to prove it.

THE (ALMOST) INSTANT ASSESSMENT

Whether your business is simply not as profitable as you would like it to be or is in full cardiac arrest, I need you to be willing to keep your eyes wide open. In order for Profit First to work, you need to come to this with no blinders on.

As you complete the Instant Assessment, remember that different businesses have different setups. I'll help you get to the perfect numbers for your specific business in the next chapter. For now, know that, while the numbers I provide in this chapter are ballpark numbers, they are a surprisingly effective way to get started, and you may be surprised at how accurate this Instant Assessment really is.

Figure 3 is the Profit First Instant Assessment form. Complete the form right now! You can write right in this book (or, if you are on an iPad or Kindle or some other reader and don't want to replace the screen, you can download a printable copy from the Resources section at Mike Michalowicz.com.)

1. In the Actual column, enter your Top Line Revenue for the last twelve full months. This is your total revenue, and

	ACTUAL	PF%	PF$	THE BLEED	THE FIX
Top Line Revenue					
Material & Subs					
Real Revenue		100%			
Profit					
Owner's Pay					
Tax					
Operating Expenses					

Figure 3: Profit First Assessment Form

you should be able to pull this number directly from your accounting system.

2. If you are a manufacturer or retailer, or if most of your sales are derived from the resale or assembly of inventory, put the cost of materials (not labor) for the last twelve full months in the Material & Subs cell.

3. If subcontractors deliver most of your services, put the cost of the subcontractors for these twelve months in the Material & Subs cell. (Subcontractors are people who work for you, but have the ability to work autonomously and to work for others. You don't pay them on payroll, you pay them their project fee, commission or hourly rate, and they handle their taxes, benefits, etc. themselves.) In some cases you will have both materials and subcontractor costs (think home construction). In that case, put the cumulative amount of these two costs in the Material & Subs cell. Remember to only put your materials and subcontracts here, but not labor costs for your own people.

4. If you are a service company and most of your services are provided by your employees (you included), put an n/a symbol in the Material & Subs section.

5. Now subtract your Material & Subs number from your Top Line Revenue to calculate your Real Revenue. If you put an n/a in the Material & Subs section, just copy the Top Line Revenue number to the Real Revenue cell.

6. The goal is to get you to your Real Revenue number. This is the real money your company makes. For the other stuff—subs, materials, etc.—you may make a margin, but it isn't the core driver of profitability because you have little control over it. This can be a real wake-up moment for entrepreneurs. That real estate agency that does $5,000,000 in annual revenue and has a couple dozen agents (subcontractors) taking $4,000,000 in commissions is really a $1,000,000 business that manages real estate agents making $4,000,000, not a $5,000,000 business. The $3,000,000 a year staffing firm that bills out subcontractors to do work, and pays those subs $2,500,000, is really a $500,000 business. The accounting firm that bills out $2,000,000 in annual fees and has an in-house staff that does almost all the work has Real Revenue of $2,000,000 a year. The Real Revenue number is a simple, fast way to put all companies on equal footing (their Real Revenue numbers).

   Real Revenue is different from Gross Profit, in that Real Revenue is your Total Revenue minus materials and subcontractors used to create and deliver the service or product. Gross Profit is Total Revenue minus materials, subcontractors and any of your employee's time used to create and deliver the service or product. It is a subtle difference but a critically important one. Gross Profit includes a portion of your employees' time. But the thing is this: You will generally pay your employees for their

time whether you have a bad sales day or a good one. You will likely pay them the same salary if they fix a car transmission in four hours or five. So, to simplify things, we categorize any employee that you have, full or part time, as a cost of the business operations, not as a cost of the good sold.

7. Now that we know your Real Revenue, write down your actual profit from the last twelve months in the Profit cell. This is the cumulative profit you have sitting in the bank, or have distributed to yourself (and/or partners) as a bonus on top of—but not to supplement—your salary. If you think you have a profit but it is not in the bank and was never distributed to you as a bonus, this means you don't really have a profit. (If it turns out that you have less profit than you thought you would, it's likely you used it to pay down debt from previous years. Or maybe you are attempting an Enron re-make.)

8. In the Owner's Pay cell, put down how much you paid yourself (and any other owners of the business) these past twelve months in regular payroll distributions, not profit distributions.

9. In the Tax cell, put down how much money you have paid in taxes over the last twelve months, plus any money you have already reserved for taxes.

10. In the Operating Expenses cell, add up the total expenses you paid for the last twelve months—everything except your profits, owner's pay, taxes and any materials and subs that you have already accounted for.

11. Double-check your work by adding up your profit, owner's pay, taxes and operating expenses to see if you get your Real

Revenue number. If you don't get this number, something is wrong with your calculations. Go fix it. Then, add your Real Revenue to the Material & Subs costs and you should get the Top Line Revenue number. Make sure it all squares out.

12. Next, enter the profit percentage in the PF % column based upon your Real Revenue Range. Use the percentages in Figure 4. I call these percentages TAPs (Target Allocation Percentages), the percentage of each deposit that will be allocated to different elements of our business.

    For example, if your Real Revenue for the last twelve months is $722,000, you should use column C. If your business has $225,000 in Real Revenue, use Column A. If you run a division (or have your own company) that does $40,000,000, use column F.

13. In the PF $ column, copy the Real Revenue number from your actual column. Then multiply that Real Revenue number by the PF % for each row and write down the number in the corresponding PF $ cell. These are your

	A	B	C	D	E	F
Real Revenue Range	$0 – $250K	$250K – $500K	$500K – $1M	$1M – $5M	$5M – $10M	$10M – $50M
Real Revenue	100%	100%	100%	100%	100%	100%
Profit	5%	10%	15%	10%	15%	20%
Owner's Pay	50%	35%	20%	10%	5%	0%
Tax	15%	15%	15%	15%	15%	15%
Operating Expenses	30%	40%	50%	65%	65%	65%

Figure 4: Target Allocation Percentages (TAPs)

target PF dollar amounts for each category. Welcome to the moment of truth. (I hope we can still be friends.)

14. In the Bleed column, take your Actual number and subtract the PF $ number. This is very likely to result in a negative number. It is your bleed, the amount you need to make up. Negative means you are bleeding out money in these sections. Sometimes it is in just one category with a problem, but in most cases businesses are bleeding out in the Profit, Owner's Pay and Tax Accounts and have a positive number (meaning excess) in Operating Expenses. In other words, we are paying too little in profit, owner salaries, and taxes, and paying too much in operating expenses.

15. In the final column, The Fix, put either "increase" or "decrease" next to each category. If the number in the Bleed section is a negative number, put "increase" in the corresponding Fix cell, because we need to increase our contribution to this category to correct the Bleed. Conversely, if it is a positive number in the Bleed section, put "decrease" in the Fix cell, since this is a category where we need to spend less money in order to fix it.

Figure 5 is a completed example from a law firm to which I just introduced this process: The Instant Assessment reveals a few (painful) things. This business is not nearly profitable enough—it should be filling the profit coffers by $118,000 more every year. At $5,000 in the Profit Account, this is basically a break-even business. One bad month and this company is going down.

The two owners are taking a combined salary of $190,000, which is way too much for a business of this size. The owners are likely living a bigger lifestyle than the business can afford, and they need to cut their salaries by $67,000.

As the business gets healthier, the taxes will increase. (More taxes, as painful as they are to pay, are a sign of a healthy business—the

	ACTUAL	PF%	PF$	THE BLEED	THE FIX
Top Line Revenue	$1,233,000				
Material & Subs	N/A				
Real Revenue	$1,233,000	100%	$1,233,000		
Profit	$5,000	10%	$123,000	($118,000)	Increase
Owner's Pay	$190,000	10%	$123,000	$67,000	Decrease
Tax	$95,000	15%	$184,950	($89,950)	Increase
Operating Expenses	$943,000	65%	$801,450	$141,550	Decrease

Figure 5: Completed Instant Assessment for Law Firm

more you make, the more you pay… until you make so much you lobby politicians and pay nothing. Don't get me started.) And those Operating Expenses are too high, to the tune of more than $141,000.

Looking at this Instant Assessment, it's obvious what this company's leaders need to do to make their business healthy: Cut owners' salaries and cut operating costs, possibly including staff. It will require courage, and it is going to be painful.

The Instant Assessment brings clarity fast, and it can be a rude awakening. No more putting things off. No more hoping that big client, big check or big anything will save you from the day-to-day panic. We know exactly what we need to do.

A financially healthy company is a result of a series of small daily financial wins, not one big moment. Profitability isn't an event; it's a habit.

WHY PERCENTAGES?

What if I told you I knew of a successful bikini model and fitness trainer who weighs 205 pounds? You would assume she was seriously overweight, right? How could she be a bikini model? Easy. She's six foot eight! Amazon Eve is the tallest bikini model in the

world and, I'm telling you, she's ripped. (Google her.) Her weight is ideal for her height. Fitness is relative. Health is relative. So are numbers.

In this book I use the phrase "top line" thinking, which is when you focus on revenue, revenue first and foremost, with profit as an afterthought. Top line thinking is dangerous because numbers are relative. You may have a million in revenue, but that's a whole lot of nothing if your expenses and debt load is also seven figures. At $500K you might view your top line as meager compared to other businesses in your industry, but if you're pulling in eighty percent in pay and profit, that is far from meager. That's gorgeous. Super model gorgeous. And if your business is showing fifty million in revenue, but pulling in two percent in pay and profit, that's ugly, my friend. Frankenstein, ugly. (And we all know how ugly that is.) So, rather than focus on actual numbers alone, look at percentages. Percentages show the relationship, giving you an accurate picture of what's really happening with your business.

HOW DID I DETERMINE THESE NUMBERS AND PERCENTAGES?

These are typical ranges that I have found while working with countless companies over the years and in running my own. The percentages aren't perfect, but they are an excellent starting point. And they represent what I have found to be very healthy numbers. But here is the deal—they may not work for you perfectly, but that is okay because these percentages are your target, what you will move toward. We are going to move in small steps. More on that soon, but here are the deets behind the percentages.

When a company is doing less than $250,000 in revenue it typically has one employee: you. You are the key employee and usually the only employee (with some contractors, part-timers, or maybe possibly one full-timer). Many freelancers are at this stage and if they elect to stay there (just them and no employees) they should be able to increase the profit and pay percentages even more than what I have listed, because they don't have the expense of

employees or the need to incur the expenses necessary to support multiple employees.

At $250K to $500K, you likely have employees. Basic systems will be necessary (like a shared CRM for your team), equipment, etc., plus you will need to pay your people, so operating expenses increase. Owner's Pay adjusts down (and will continue to) as you take your first step in being a little less employee and a little more shareholder, when other people start to do the work, and you get the benefit of the profits via your distributions.

At $500K to $1M, the growth trend and patterns continue with more systems and more people. Focus on increasing profits because, for so many businesses, the growth from $1M to $5M is the hardest. You want a little reserve.

From $1M to $5M, systems are no longer added because they are nice to have; now systems become absolutely mandatory. You can't keep it all in your head any more. Often the biggest investment into the business needs to happen at this time, as all the knowledge in your head needs to be converted to systems and processes and check lists. This means larger allocations must be put toward Operating Expenses. This is when you are no longer doing most of the work; this is when, if your business is to grow, a significant portion of your time is spent working on the business (not in it), and the rest of your time is spent selling the big projects.

At $5M to $10M, typically a management team enters a company to bring it to the next stage, and a clear second tier of management starts to form. The founder starts more and more to focus on her special strengths. The owner is on a consistent payroll, and the majority of her take home income is from the profitability of the company, not the salary she takes.

At $10M to $50M, a business will often stabilize and achieve predictable growth. The founder's income is almost entirely made up of profit distributions. Owners' salaries are relative to their roles, but typically are insignificant. Businesses of this size can leverage efficiency in big ways to maximize profitability.

RUDE AWAKENING

You might remember that during my "rebuilding" period, I wrote my first book, *The Toilet Paper Entrepreneur;* the foundation of which was a series of principles I used to start my businesses. Chief among these principles was frugality—I wholeheartedly believed that any entrepreneur could start a business with little or no seed money and grow that business no matter what they had in the bank. The book is full of tips for saving money while launching and running a business, and since its publication I've heard from thousands of entrepreneurs who followed the advice (or a variant thereof) while starting or operating their own businesses.

And let me tell you, I didn't just spout off about frugality. After my spending craze, after my come-to-Jesus moment (if Jesus were named "near bankruptcy"), I went back to my roots. Way back. Not because I had to, this time, but because I wanted to. I made it my mission to get what I needed for my business on the cheap and took pride in doing so. My office space cost a mere $1000 per month—peanuts compared to my previous $14,000 a month digs. I got my gently-used conference room furniture for a whopping 75% discount. My dry erase board was homemade, with white board material used in showers, dental floss and some car wax. (Top that, MacGyver!)

So imagine my surprise when I ran my own assessment on my business and discovered that, despite my frugal superpowers, I was still bleeding out. It is not an exaggeration to say I was shocked to discover this. "How much cheaper can I get this stuff?" I thought, beyond frustrated.

Then I realized—duh. It wasn't how *much* I was spending on expense line items. The problem was, I shouldn't have been spending *anything* on some of those line items. For example, I didn't really need an office space. I wasn't seeing clients or greeting customers. I was writing a book and building a speaking career, which meant I spent a lot of time alone, on the road and in phone and Skype meetings. My subcontractors could just as easily do their work from home.

Truth was, I *wanted* an office space because it made me feel legitimate. And let me tell you, after my piggy bank moment,

I needed to feel that. But the bottom line was, I couldn't keep it up if I wanted to turn a profit every month. So I sublet my office space and found a sweet deal at a cookie factory—free office and meeting space from a trusted, long-time friend. I cut expense line items across the board until I stopped the bleeding and watched my business and profit grow. An added bonus was free cookies. And when I say added bonus, I mean it added about five pounds around my waist. So… not really a bonus, after all.

For some people, the Instant Assessment brings about a rude awakening that is far more devastating than mine. I'd already been through the wringer, so realizing I had to cut a few line items was a shock, but not a big deal. Cutting cost has become almost enjoyable. It has become strategic in a way. How can I achieve the same or better with less or no cost? For Debbie Horovitch, whose story I shared with you in the introduction, the rude awakening led to a near-breakdown with a total stranger (me—so, you know, a "very handsome young man," according to my mom). It led to Debbie feeling like a fool.

I have applied the Instant Assessment to countless businesses, and the reactions vary from, "Really? I can do that?" to "Who the hell do you think you are, Mike, telling me where my business should be? You know nothing about my unique industry!" to buckling knees and tears streaming down people's faces. It's hard to face the harsh reality that your business is worse off than you thought it was. But now you know, and knowledge is power. Now we can fix it.

You are not a fool. You have done nothing wrong, and you have nothing to be ashamed of. You have this book in your hands. You are discovering the truth and another way to get where you want to go. You are no longer asking, "How can I make my business bigger?" You are asking, "How can I make my business healthier?"

WHAT IF YOUR BUSINESS IS BRAND NEW

How does Profit First work if you just launched your business and have no revenue? Should you wait until you have some to start using

Profit First? Heck, no. Starting with squat, with your whole business future ahead of you is actually the best time to start using Profit First. Why? Because it allows you to form a powerful habit right from the get-go, when your business is forming and, perhaps more importantly, prevents you from developing bad financial habits that can be difficult to break.

A baby is a poor indication of what a person will look like as an adult; the same is true for a brand new business. You may end up serving a different type of client than you plan to serve right now. I suspect the founder of Ugg, who initially made the popular line for surfers, never imagined teenage girls would become his primary market. Also, in the early stages of building a business, you need to spend as much time as possible on the selling and the doing; systems and processes come later. For these reasons, it's best not to worry about getting the exact right percentages for your business.

Simply use the percentages in the Instant Assessment for your target allocations, but start at 1% allocation for the Profit Account, 50% for Owner's Pay and 15% for the Tax Account. Use quarterly adjustments to step up to higher percentages and nudge your business closer to the TAPs recommended in this book. And as for the advanced Profit First strategies I share in the end of the book—don't worry about any of that until your business has been active for at least a year. The goal for new businesses is to form the basic core good Profit First habit and then spend every other waking second getting your baby off the ground.

ACTION STEP

COMPLETE THE INSTANT ASSESSMENT

Step 1 (the one and only step): This entire chapter is really one big action step, so if you have not yet completed an Instant Assessment on your business, do it now. Can you get a lot out of this book if you table this exercise for when you have more time or feel up to facing reality? Sure. Will you get the most out of reading this book and see results quickly if you don't? Nope. So stop right now and do it.

PLEASE READ THIS NOW

If you are feeling overwhelmed, bad about yourself and the choices you've made, or angry about the numbers you came up with in your Instant Assessment, there is something I want you to know:

You are normal.

If you are having trouble facing the rest of this book, that's okay. Stop now and come back to it when you feel ready to face it. But do this one thing: set up a Profit Account at a separate bank and, every time you make a deposit, move one percent into that account. I know it's "peanuts" and you may think the amount is too small to make an impact on your business, but that is the reason you're going to keep the profit allocation percentage low. You can run your business as you always have, and you won't feel a thing, but you will start the habit that will change your business forever. Soon enough, the feeling of being overwhelmed, the anger and frustration, will fade as your new profit habit builds. Then you can crack this book again and dig in to the rest of the Profit First system.

4 CHOOSE YOUR OWN ADVENTURE

When I was a kid, I loved reading *Choose Your Own Adventure* books (and quite frankly, I'll still dig into an R.A. Montgomery book if it crosses my path). You know, the interactive books with a message at the end of each chapter that says something like: "If you want to take the path through the woods, turn to page 51. If you want to take the boat, turn to page 80."

Here's your chance to relive a part of your childhood—you get to choose which Profit First adventure you want to have next. The only difference between this and the classic *Choose Your Own Adventure* books is, no matter which page you turn to, as long as you follow the Profit First system you will be victorious. Simply choose a path that fits your needs right now. But whichever path you choose, the ending is the same no matter what: perpetual profit.

Let's get to it. Time to pick your direction in your adventures in profit. You put your sword back in its sheath. You raise your torch high, illuminating the room. A large pile of cash sits in front of you, ready for the taking. You choose what happens next:

1. You are the type who wants to continue on with this adventure, now. So you quickly scoop up the pile of cash, stuff it into your backpack and draw your sword, ready for the next challenge. (If you want to start implementing Profit First right this second using your Instant Assessment percentages, turn to Chapter 5.)

2. You are the type who accounts for the details. Is that a black widow spider crawling amongst the bills? And what's that

slimy, slithering thing peering at you from the corner of the room? Is it a snake—or worse, an IRS agent?

You carefully count and stack every single dollar, write out a receipt and place the money securely in your backpack. The next adventure will surely present itself, but for now you'll cross every T and dot every I. (If you want to master the nuances of the Instant Assessment and come up with percentages that are perfectly suited to your business, then continue reading this chapter.)

Note: There are a lot of numbers in this chapter. If you choose option 2 and make it through this chapter alive, tweet me a selfie.

There is no wrong choice. You may want to jump right in and come back later to tweak your percentages. Or you may want to come up with a customized assessment so that you don't *have* to come back later. Either way, as long as you're actually working the Profit First system, you're winning.

GETTING DOWN TO THE NITTY-GRITTY

The Instant Assessment is based on ranges. Every business is slightly different (though your business and your industry are not nearly as unique as you may think). The numbers you came up with in the Instant Assessment won't be perfect, but they are probably close to what you'll end up with after a more detailed assessment.

Before we dig in, I want to address two common problems entrepreneurs face when they decide to start following the Profit First system—and they do not go hand in hand.

First, some entrepreneurs make the mistake of getting trapped in the details, spending hours, days, weeks or longer perfecting their percentages before they *do* anything. Worse, some entrepreneurs who get stuck in the minutiae never get around to doing anything. It's our old nemesis: analysis paralysis. In this chapter, we get down to the nitty-gritty; but if at any time you think you are lost in a research and percentage-tweaking rabbit hole, stop and move on

to the next chapter. Perfectionism kills every dream—better to just start.

On the other hand, if you're like me, you might make the common mistake of taking action too big and too fast. I'm the type who starts before I have all of the information because most of the learning occurs in the doing, anyway. But I put success at risk when I go into a situation ill-prepared. In those cases, my ego blames the system when mistakes were simply due to the fact that I didn't put in the necessary preparation.

I've seen entrepreneurs kickstart their Profit First system by taking a profit percentage of twenty percent immediately. They say, "This is so simple. I get it. Bammo! Twenty percent! I'm done. Next problem."

Not so fast, Chiefy. This is a classic mistake, one I've made myself. Going full-throttle Profit First on the first day is like donating five gallons of blood at your first blood drive. You know what would happen if you tried to do that? You would die. The body has less than two gallons of blood pumping through it, so you'd keel over way before you reached your five-gallon goal anyway. However, there is a way to reach that goal in a safe way. If we donate small amounts over time, eventually we will donate five gallons—cumulatively.

If you hoard most of the food at the table, you're not leaving any fuel for your business. Remember, your business, not you, is now living off of the leftovers. So make sure the share you take leaves enough for your business to continue to thrive. Rather than go with one extreme—too slow or too fast—let's just meet somewhere in the middle.

The key to successful Profit First implementation lies in stringing together a series of many small steps in a repeating pattern. So take it easy.

While you slowly start to build up your Profit First muscle, we are also going to get you into a simple, repeating pattern. All music has a rhythm. Rhythm is what moves the music forward, and moves you. Otherwise it would just be random noise, and you would never be moved by it. Entrepreneurs typically manage their money in an

erratic, noisy rhythm that causes confusion and panic. But by the end of the next chapter, we will get you into a simple rhythm that will give you clarity and control over your financials.

Let's dig in.

YOUR PROFIT TARGET ALLOCATION PERCENTAGES (TAPS)

The Instant Assessment is a starting point for all of your Target Allocation Percentages (TAPs). TAPs are the goals we have set to distribute to each account based on percentages. We may want to ultimately be tucking away 20% of our accumulated deposits; if so, 20% would be the TAP for Profit. We won't necessarily start there, but we will build to it.

Now you need to do a little bit of research to set more specific target numbers. There are a few ways to approach this:

1. Research public companies: Look at the financial reports public companies are required to make available. Do a quick Internet search using the term "financial market overview" and you will find dozens of websites that report the financials for public companies. Look up at least five companies in your industry, or a similar industry. If you don't find your niche, try expanding. For instance, if you find no public DJ companies, expand to entertainment companies and select five that come close. (Tip: My preference is Marketwatch.com for these reports, because the site is easy to navigate. You might also try Yahoo! Finance and Google Finance.)

   For our purposes, look up the income statements for the last three to five years. If you really want to dig in, check out the balance sheets and cash flow statements for these companies, too.

   For each year, divide the net income (profit) number by the total sales/revenue number. Do this for each year and then come up with the average. This is how you find the profit percentage for any public company. Do this for each

of the five public companies you look at, and you will find the overall industry profit average.

Use that overall industry profit average as your Profit TAP.

2. Review your tax returns for the last three to five years and determine your most profitable year (based on percentages, not on dollar amounts). Why do we want the percentage? Because a billion-dollar company that only reports a million dollars in profit is in big trouble. Even if they only had one bad day, a million bucks wouldn't be enough to bail them out. But a five million-dollar company that reports a million in profits is kicking butt and taking names. That lil' ol' company spits at bad days.

3. Or, the easiest way, just pick your profit percentage number based on your projected revenue for this year, using revenue for the last twelve months from the Instant Assessment form you filled out for Chapter 3. (You did fill it out, right?) Remember, the form is also available for free download in the Resources section at MikeMichalowicz.com.

If more than half the stuff your company sells comes from materials rather than labor or software—as happens with manufacturers, restaurants and retailers—use the gross profit (sometime called gross income) as the Real Revenue number. Gross profit is calculated somewhat similarly to how I suggest you determine your Real Revenue, and you need to evaluate your business based on that. Whenever you run the numbers for your business, or evaluate others, you will always base it on Real Revenue (gross profit).

Since at this point your Profit Account will fund your profit distributions and serve as your rainy day fund, you'll want your Profit Percentage to grow past five percent quickly. If you save five percent of your company's annual income, for example, that represents about twenty-one days of operating cash, which would help you keep your

business afloat if your income were to plummet. (If your income dried up, you would stop contributing to your Profit Account and Tax Account and stop profit distributions to owners.) Three weeks is not much time to fix the problem, but Armageddon rarely happens. More often, revenue slows down over time, and you'll have at least something coming in during lean times. Kinda like a "Hangnail-ageddon" instead of an Armageddon. (It's a bad joke, I know, but I like it. So it stays.)

If your sales were to stop completely, with not a single deposit coming in, here's a good longevity rule of thumb:

1. 5% profit allocation = 3 weeks of operating cash

2. 12% profit allocation= 2 months of operating cash

3. 24% profit allocation = 5 months of operating cash.

Why is it that, as the PF percentages basically double, longevity almost triples? The math doesn't seem to make sense at first glance. But it does make sense. The bigger your PF percentage, the more efficiently you are running your business, which means less in operating expenses. So not only do you have more saved up with a higher PF percentage, you spend less, which affords you even more time.

The goal is to make your PF as high as possible. However, super-high profit percentages are not sustainable. At least not for long, and definitely not if your revenue stays stagnant. The reason for this is, if you can pull off consistently fat profits—say 50% allocated to your Profit Account—and your Operating Expenses Account for only 10% of revenue, your competitors will figure out what you're doing. Then, to get more business, they will drop prices (they likely have the profit margins to afford it). When that happens, you will have to drop prices too in order to stay in business. For competitive sharks, fat margins can be like blood in the water. The only way to keep big margins is to milk them for all they're worth when

you have them and keep innovating to find new ways to bump up profitability.

OWNER'S PAY TAPS

Gone are the days when you paid everyone but yourself and had to support your life with credit cards and loans from the in-laws. Remember, your business is supposed to serve you; you are not in service to your business! No more leftovers for you!

Owner's Pay is the amount you and the other equity owners take in pay for the work you do. (Equity members of your company who do not work in the business just get a profit distribution.) Your salary should be on par with the going rate for the work you do, in other words—the salary you would have to pay your replacement.

There are two options to consider when choosing your Owner's Pay TAPs number. Either:

1. Take a realistic look at the work you do. If you have a small company with, say, five employees, you may call yourself the CEO—but that's just the title on your card. Likely, you are doing a lot of other work. You probably spend a lot of time selling, completing projects, handling customers and dealing with HR concerns. In reality, around two percent of your time is spent actually doing the job of CEO—vision planning, strategic negotiations, acquisitions, reporting to investors, addressing the media, etc. Determine your salary based on what you are doing 80% of the time, and what you would reasonably pay employees to do those jobs.

2. Evaluate pay for all equity owners who work in the business. Add up the salaries that represent your Owner's Pay draw. The percentage of revenue must, at minimum, cover Owner's Pay draw. Remember, you will likely get raises—maybe even a bonus for a job well done. So make the percentage one-and-a-quarter times the amount you determine for your salaries, so you can adjust for revenue fluctuations.

Or, pick the percentage I suggested in the Instant Assessment, based on your revenue range. (Refer to Figure 4.) The money that is transferred into this account is divided among all equity employees. It does not have to be split up equally, nor does it have to be split up based on your equity percentages.

Why should you have a separate account if you and the other equity owners working in the business are just employees? Because you are the most important employee. If you had to fire people, I suspect you would fire everyone else before you fired yourself. Think about your very best employee. I'll bet you take extra steps to ensure that you are taking care of her. I'll bet you would do everything in your power to keep your best employees happy, including paying them what they're worth, right? Well guess what, Bucko! *You* are your best, most important employee. We must take care of you.

When it comes to pay, different business formations require you to take Owner's Pay in different ways. An S-Corp is treated differently than an LLC or a sole proprietorship, which are both treated way differently than a C-Corp. The Owner's Pay allocation still works the same way; you just need to work with your accountant to make sure the money flows out properly and legally. (I strongly recommend an accountant who is a certified Profit First Professional, meaning they get this and know exactly how to support your Profit First business.)

WHEN YOUR CURRENT PAY IS LESS THAN THE ASSESSMENT

I was having dinner with my friend Rodrigo when he told me how his business generated $350,000 in annual revenue, but he was living on below-minimum wage.

As a thunderstorm approached in the distance, I took the napkin with the least amount of salsa stains and jotted down Rodrigo's numbers. Multiplying his $350,000 in Real Revenue by 35% (from the Instant Assessment), I came up with just over $122,000.

"How many partners work in the business?" I asked.

"Me, and one other," he replied.

Dividing by two, the amount for owner's pay was a little over $61,000 each, but that was if they were doing the same work, warranting a fifty-fifty split. As we discussed in the previous section, owner's pay should represent the work you do.

When I asked Rodrigo for more details about his own pay, he said, "I take roughly $30,000 a year, and my partner left to get a full-time job, so he takes zero now. We have three full-time employees at $65,000 each per year, and I manage them."

I'd like to say I was shocked, but this scenario is all too common. I did wonder how Rodrigo was supporting himself and his family on below-minimum wage. I figured he was using credit cards, family loans and possibly a home re-finance to supplement his paltry income.

"If all three of your employees decided to leave on the same day, what would you do?" I asked.

"I would do all of the work myself and my partner would come back."

"So why don't you do that?" I asked.

"Because then I would be stuck doing the work and it would not be able to grow," Rodrigo explained. "I don't want to do the work; I want to grow the business."

Rodrigo had the right idea, but he was executing it in the wrong way.

In *The E-Myth Revisited,* the classic must-read book by Michael Gerber, Michael explains that we should work *on* our business, not *in* it. (Yes, I call him Michael. We are friends. He calls me Mike and I call him Michael. And occasionally I call him Mike and he calls me Michael. And then we both get confused and start talking to ourselves.)

This "on vs. in" philosophy is spot-on, and yet most entrepreneurs have trouble executing it. Working *on* the business does not mean hiring a bunch of people to do the work and then spending all the livelong day answering their never-ending questions about how to do the job (the job you used to do). Shifting to a managerial role just means you are working *in* your business in a different way—and that you have a mongo payroll to cover every two weeks.

Working *on* your business is about building systems. Period. An entrepreneur is someone who finds the solutions to opportunities and problems and then builds systems to consistently deliver those solutions through other people or things.

However, what Rodrigo and so many entrepreneurs miss is that growing a company is not an overnight switch from doing all of the work to none of the work. The transition from working *in* the business to working *on* the business happens over time—slowly, deliberately, one small step followed by another small step. (Are you starting to see the theme here?) This is the reasoning behind the Owner's Pay percentages in the Instant Assessment—larger percentages for owners when the company is tiny and smaller percentages as the company grows.

In the early days of a company, when annual revenues are below $250,000, you are not only the most important employee; you are likely the *only* employee. If your annual revenue is under $500,000 and you have an employee or two, you are still the key employee. And that means you must be doing 90% of the work. You're bringing home the bacon and frying it up in the pan.

The other 10% of the time you spend documenting everything you do so that you can systematize it for your other few employees or contractors to do the work without your input. Basically, you are a true entrepreneur (building systems) 10% of the time, and a hardworking, hard-selling employee of your own company 90% of the time.

This is why you get such a big salary in the beginning. No more of this "bottom of the bowl" stuff. You can't live on minimum wage or less. Say it again, once more with feeling: *My business serves me; I do not serve my business*. Paying yourself next to nothing for hard work is servitude.

As your annual revenue grows past $500,000, you will transition to spending more time building systems. Now, you're a systems developer 20% of the time, a manager 10% of the time and an employee 70% of the time. (Note that the better you are at creating systems, the less management is required, because the recipe for how to things get done is consistent.)

As annual revenue grows past one million, your salary percentage will drop even farther because you will be working less and less *in* the business and more and more *on* the business.

However, remember that it is likely you will always work *in* your business. Because even if you are a master of building systems and spend 80% of your time in that magic zone, you'll still spend roughly 20% of your time handling the big sales. Almost every entrepreneur to CEO is in charge of the big sale. You bet your bottom dollar Jeff Bezos is in the room when Amazon is closing a hundred million-dollar deal. And when your big deals are on the table, you will be right there, sitting at its head.

Ironically, getting back *in* your business is the best way to create systems. And as you put the systems in place and your revenue increases to accommodate them, you can slowly plug in great people to implement those great systems.

The bottom line is this: Don't cut your salary to make the numbers work. The goal of every business is health, and that is achieved through efficiency. Your martyr syndrome is not doing anyone any favors; making yourself the sacrificial lamb does not promote efficiency, it hinders it.

YOUR TAX TAPS

Profit First is not about accounting to the exact penny (that's what your bookkeeper and accountant do). It is about handling your accounting quickly and easily, with numbers that are as close to accurate as possible. We work percentages off of the Real Revenue number and this is true for all your "small plate" accounts.

The first step in getting to your Tax TAP is to determine your income tax rate. Taxes range all over the place, depending on your amount of personal income and corporate profit and the area you live in. As of this writing, many entrepreneurs have an average income tax rate of 35% or so; for others it will be less, and in some countries is can be 60% or more.

When I traveled to Copenhagen, Denmark, the beauty of the country blew me away: the resources they have, and all the "free

stuff"—the free healthcare, the free education (including universities), and the free-flowing confidence that they live in the best place in the world, which is kind of funny, because I always thought North Korea held that title.

Then my friend Lori Webb told me that the Danish tax rate is over 60%. I practically fell off my chair.

Taxes vary from country to country, income bracket to income bracket, and surely change everywhere every year (and, I think, in world history, never once in our favor). But regardless of what the numbers are, you need to prepare for them.

One goal of the Profit First system is that the company takes care of all forms of tax responsibility. It's mandatory that you talk with your accountant so she can advise you on all the ways you and your business will be taxed.

Here are four different approaches for determining your Tax TAP:

1. Look at your personal and business tax returns. Add up your taxes and then determine the percentage of taxes you paid compared to your Real Revenue. Do this again for the prior two years. Looking at your taxes as a percentage of Real Revenue for the last three years will give you a good sense of your ongoing tax responsibility.

2. From your accountant get your estimated tax responsibility for your business, year-to-date (YTD), and then determine your tax percentage of your YTD Real Revenue. Better yet, if your accountant is a certified Profit First Professional, she can simply tell you the percentage to reserve. (For a list of accountants, bookkeepers and other financial gurus who are Profit First Professionals, go to the Resources section at MikeMichalowicz.com.)

3. Do a search for "tax rates" + "your country" + "tax year." For example, "tax rates United States 2013" yielded the following results on Google:

Tax Rate Schedule Y-1, Internal Revenue Code section 1(a)

10% on taxable income from $0 to $17,850, plus
15% on taxable income over $17,850 to $72,500, plus
25% on taxable income over $72,500 to $146,400, plus
28% on taxable income over $146,400 to $223,050, plus
33% on taxable income over $223,050 to $398,350, plus
35% on taxable income over $398,350 to $450,000, plus
39.6% on taxable income over $450,000.

Then, pick your likely income range—which depends on the type of company formation you may have and the combination of your Owner's Pay and Profit contributions—and you have your federal tax rate. Now do the same thing for state taxes and add the two.

4. Or simply use 35% as your tax number. It may not be perfect, but it's usually pretty effective. And while the optimal number will have you neither paying additional taxes at the end of the year nor receiving a refund, it is better to guess a little too high, get a refund and consider what to do with the extra cash than to get a call from your accountant, Keith, because you don't have enough money, and have to ask your daughter if you can borrow from her piggy bank. Trust me.

But hold on: If the tax rate is 35%, why would I only reserve 15% for taxes (as noted in the Instant Assessment I shared earlier)? Let's do a little simple math.

A LITTLE SIMPLE MATH

Now we are going to determine the percentage that stays in your Operating Expenses Account, after you move money to your Profit Account, your Owner's Pay Account and your Tax Account. The amount left over for expenses is likely going to be somewhere between 40% and 60%. This is the money you have available to pay all your expenses.

Next, subtract that percentage from 100%. So, if your total Operating Expenses Account is at 55%, you're left with 45%. That 45% is the amount you will be taxed on. (More often than not, expenses are not taxed. This is why some accountants encourage you to buy equipment or make other large purchases toward the end of the year.) Now, multiply your non-operating percentage (in this case, 45%) with your taxable income percentage (in this case, 35%). You end up with a percentage of approximately 16%, which is your Tax percentage.

Now that you have a more accurate picture of your actual percentages, you're ready to get started. In the next chapter we'll take you through the first year of Profit First, and beyond, and outline everything you need to know from day one. Congratulations! You survived. Send me a selfie.

I can sense your hunger to put this into practice in your business. Wipe that drool off your chin and let's start doing it. Things are about to change around here.

ACTION STEP

APPLY YOUR ADVANCED KNOWLEDGE

Step 1: Following the steps detailed above, determine your custom Profit, Owner's Pay and Tax percentages based on your industry and other factors.

Step 2: Since you chose to get down to the nitty-gritty and determine your exact Profit, Owner's Pay and Tax percentages, stop now and adjust the numbers in your Instant Assessment form.

5 DAY ONE, QUARTER ONE, YEAR ONE AND FOREVER

Profit First works. Period. Whether you use the percentages I provided for you in the Instant Assessment or choose the path of assessing all the nuances of your business and industry (see Chapter 4) and arrive at your own perfect allocation percentages, it will work. How can it work with different percentages, you ask? Because your Target Allocation Percentages (TAPs) for your Profit, Owner's Pay and Tax Accounts are simply targets—you aren't going to start with them, you are going to build toward them. And as you build, you will transform your business into a lean, mean efficiency machine that generates profit on every deposit, no matter how small.

Remember, the Profit First formula flip is easy:

Sales – Profit = Expenses

If you're still stuck on finding your percentage, let me tell you a little story about the power of just doing it. This is a story I heard secondhand, maybe even seventeenthhand; I'm not sure. And while I don't know exactly whom the story is about, don't doubt the story. It goes like this:

An up-and-coming motivational speaker went to a speaking boot camp. During one of the sessions, the instructor explained how to make back-of-the-room sales. He said, "When you follow this method, eighty percent of the audience will buy your product at the end of an event."

With pages of notes and tons of enthusiasm, our up-and-comer set forth on the speaking circuit. Initially, she closed only 25% of her audiences. Reaching for that 80%, she tweaked and improved her

strategy and pitch, constantly reviewing her notes. Over time her close rate rose to 50%, then 60%. After another year, she was consistently selling 75% of the room after her speech. She had achieved outstanding results, but not to the level her instructor had promised.

One morning, she sat down to breakfast with a few colleagues and her old instructor happened to be there. She couldn't wait to speak with him and get direction about what could help her get that last, elusive 5%. What was the secret to finally breaking 80%? When she told her story to her instructor, his jaw dropped.

"Eighty percent? You thought I said eighty percent? I said eighteen."

I tell you this story to illustrate something I believe to be true because I've experienced it—no matter what the number is, if you work toward it and believe it's a possibility, you will not only achieve it, you will blow past the "reasonable" numbers others have set.

If you made the detailed assessment in Chapter 4, you probably looked at quite a few public companies that are in the same space you are. You have seen their numbers. You have seen their "reasonable" 18%. That's my fear.

Even if you are following my guidelines and pushing for healthy profits of 15% or 20%, the number may be too low. Many companies have absolutely done better. Million-dollar companies have posted 40% or more in profits. Yes, they are the exception, but someone has to be. Why not you? Why not choose to hear 80% when the rest of the world chooses to hear 18%?

In this chapter, I will teach you exactly how to implement Profit First, step by step, day by day, month by month, and so on. Your Profit Percentage may seem steep or out of reach, but by the end of this year you will be closer to it than you thought you could be. You may even leave it in the dust.

BEFORE WE BEGIN, MEET THE PRIDE OF PROFIT FIRST

When Jorge Morales and Jose Pain started Specialized ECU Repair in 2007, they dreamed of one day enjoying what they perceived to be the big perk of owning a business: profit, or, extra money to spend

on their own interests. (Jorge is really into free diving and Jose has a serious thing for model airplanes.)

Here's where many seasoned entrepreneurs chuckle knowingly under their breath because they think this Jorge and Jose are dreamers. Don't they know that entrepreneurship is about personal sacrifice? Unless they're exceptionally lucky, it will be a long time before they earn enough extra cash to indulge in their little hobbies… right?

Wrong.

Two years into operating their own business, Jorge and Jose had decided the only way they could reap the benefits of entrepreneurship would be to increase their salaries a little bit each year. (They were better off than most entrepreneurs in that they *did* have enough to pay their own salaries and hadn't fallen into the death trap of debt.)

Then they read the small section on Profit First Accounting in my book, *The Toilet Paper Entrepreneur,* and began applying the system almost immediately. Over the next few years, Jorge and Jose tweaked Profit First to suit their rapidly growing business, adjusting their Profit Account percentages and allowing Profit First to control that growth so that they never ended up underwater because of large purchases or a ridiculously high payroll.

Four years later Jorge and Jose have a thriving business that, in 2013, surpassed their accountant's revenue projections. Their staff has tripled, but thanks to their shrewd, careful planning and the Profit First system, they are not struggling under the weight of too-high operating expenses.

More importantly, their business is serving them, with salaries appropriate for their positions and the work they do at Specialized ECU Repair, and with significant Profit Account disbursements that have enabled them to live the lifestyle they envisioned when they started the business.

The dream all entrepreneurs have—that our business will *improve* the quality of our lives, not destroy it—Jorge and Jose are living that dream. They do not serve their business; their business serves *them*.

DAY ONE

TELL YOUR PEOPLE

Before you begin, I want you to tell your accountant what you're up to. A warning—he might not "get it." He may say the system is useless, or it won't work, or it's technically wrong or it's too much hassle. If your accountant discourages you from using Profit First in your business, it is because he does not fully understand cash flow management or human behavior. Get a new accountant.

Jorge and Jose included their financial professionals in the implementation of Profit First right from the start.

"When we first learned about Profit First, it made sense to us," Jorge told me, in one of our many phone calls about their progress. "I pulled the numbers and then, with our bookkeeper and accountant, we did a projection for the year. Then we worked in the Profit Account percentage we wanted to start with."

With buy-in from their accountant on the principles and processes of Profit First, Jorge and Jose have been able to systematically apply the method to their business with great success. Their accountant helps them meet their Profit First goals and stay the course.

To make your life easier, I have compiled a list of accountants, bookkeepers, financial planners and others certified as Profit First Professionals. They not only get Profit First, they use it for themselves and they use it with their existing clients. You can find the list on the Resources section at MikeMichalowicz.com. There you will also find a Profit First One-Sheet that gives a basic overview of the system so that all of your key financial staff/vendors can get up to speed within a few minutes.

SET UP YOUR ACCOUNTS

If you didn't set up your accounts after reading Chapter 2 (shame on you), do so now. Most bank accounts allow you to assign a nickname to the account that is displayed, rather than just the account number. Give each account a name that is easy to identify and then put the percentage (or dollar amount—I'll explain that

in Chapter 9) in the name in brackets. This makes running Profit First so much easier. For example:

OPERATING EXPENSES [45%] *8812
OWNER PAY [25%] *8833
PROFIT [15%] *8843
TAXES [15%] *8839

START OUT EASY

We are making progress now, baby! We have the accounts set up at your bank! Yippee. We have determined your TAPs. Now we're going to start with a manageable Profit Percentage that will allow us time to cut down on expenses and adjust to the new system.

We'll start at our historical contribution levels for each account and then add 1%. This may mean you start from zilch. If your business has never had a profit, or if you have sometimes had a profit and sometimes a loss, your profit has been zero. Therefore, our easy start for the Profit Account will be 1% (that's 0% historically plus 1%, starting today), and we will bump it up as we start getting into our quarterly rhythm.

If your taxes were usually 5% of your total revenue, we are going to set up your tax reserve at 6%. If your pay represented 20% of your income, we add 1% to your 20% and you have 21%. And so on. Even if our targets are much higher, we start with what we've got, plus 1%.

Why start with small percentages, when we likely could do more? The reason is, the primary goal here is to establish a new, automatic routine for you. I want the amounts to be so small you don't even "feel" them. The goal is to set up these automatic allocations immediately, and then adjust the percentages each quarter until we are aligned with our TAPs.

Practical to the core, Jorge and Jose started out with a modest Profit First percentage of 2%. (Because their decision was made more than four years ago, before I finessed this system, their number was not based on the "1% rule" I've just shared with you.) They chose an allocation of 2% because initially, Jorge was reluctant to begin

implementing Profit First—even though he knew it made perfect sense.

"I think by going slowly, I was able to see how Profit First could work," Jorge explained. "What it really came down to was, I realized that at two percent, there was no excuse not try it. Because if your business can't afford to set aside two percent of your revenue, it's probably not a business worth pursuing."

Start slow. These percentages you set are your quarterly allocation percentages. We are going to use them for the rest of this quarter, whether the quarter begins next week or in ninety-one days.

PROFIT STARTING TODAY

You know the saying, "Today is the first day of the rest of your life." I love it. I absolutely love it. To me, it represents the profound realization that we can change our lives (and our businesses) in a moment. Now is the time. This very *moment* we will make a profit for your business, and we will be profitable every day going forward. Please don't just read this and move on to the next chapter. I want you to take action now.

Right now, this moment, look at your bank balance in your Operating Expenses Account. Then subtract any outstanding checks and payments you have from that account. Divide up the remainder into your accounts based upon your TAPs. For example, say you have $5,000 in your bank account, and you have $3,000 in checks and payments still waiting to clear. That means you have $2,000 currently available. Run your percentages on that $2,000 and move that money into the accounts.

Do you have any deposits to make today? If so, tally up the deposits, put them in the bank, and then *immediately* distribute the money to all the other accounts. Do this for every deposit going forward.

(Don't worry: you don't need to do this every single day, or many times a day, if you have lots of deposits. We are going to get you into a twice-a-month rhythm shortly that will make this process very manageable.)

OUR FIRST CELEBRATION

Congrats! And I am not saying that lightly. You've just taken a big step. This is likely the first time in your entire business life that you have deliberately accounted for your profit first. Before anything else, you made sure you addressed your profit, your personal income and your tax responsibilities. That's a big deal. And it is a big step to a very, very healthy business. Kudos to you.

SLICE EXPENSES

Now that we are moving money into our Profit, Owner's Pay and Tax Accounts, we need to get the money from somewhere. There are only two ways to do that: by increasing sales and by cutting expenses. Increasing sales is very doable (you did read *The Pumpkin Plan,* right?) and is the key for colossal profitable growth. But it takes time and it won't happen overnight. Cutting expenses is generally a very quick process and is usually very easy.

Jorge and Jose run their business based on what they can afford today, not what they hope to be able to afford someday. So sometimes they have to wait to hire someone or make a high-ticket purchase.

"When big expenses showed up," Jorge explained, "we would sit down and ask ourselves, 'Do we really need this?' If we determined it would hurt our profits at the end of the year, we didn't buy it."

We just accounted for at least 3% (1% in each of the Profit, Owner and Tax Accounts) of our income, so we need to cover that by cutting 3% from our expenses. To do that, I need you to print out two things:

1. All your expenses for the last twelve months.

2. Any recurring expenses: rent, subscriptions, Internet access, training, classes, magazines, etc.

Now add up all the expenses and then multiply that number by 10%. You must cut costs by 10%. Now! No ifs, ands or buts! So why cut by at least 10%, when we "only need 3%"? Because cutting costs doesn't mean the bills go away overnight. It may take a month or two to pay

down balances owed on expenses we eliminate. More importantly, we need to start building cash reserves, because by the start of the next quarter, we are going to move another 3% to your Profit, Tax and Owner's Pay Accounts, and then another 3% the quarter after that. So we want to account for that money quickly.

You can easily find your first 10% in cuts by doing the following:

1. Cancel whatever you don't need to help your business run efficiently and keep your customers happy.

2. Negotiate every remaining expense, except payroll.

I share a lot more about cutting expenses in the coming chapters. You are about to become a frugal (not cheap) entrepreneur. You will learn to use only what you need and not be wasteful. You will pay fairly for what you use, but you will use less. And you are going to *love it*.

MONTH AFTER MONTH

THE 10/25 RHYTHM

You remember my friend Debra Courtright, the bookkeeper who helped bail her client out of sales tax hell? When I first taught her how to use Profit First with her clients, I drove to her office in Fairfield, New Jersey to spend the day going over all of the advanced strategies. Just an hour into our training day, she had not only mastered the concepts, she was on the phone with one of her clients, helping her set up a Profit Account.

I always have my mobile office with me (backpack with laptop, other electronic gadgetry and critical lifesaving essentials—like Milano cookies). So while Debra went over the basics with her client, I knocked out a few tasks on my to-do list. I knew I had some bills due, so I went into my online bank account, looked at the Operating Expenses Account and ensured that all of the disbursements were current. Yep—Profit Account was up to do date. Tax Account looked good. Owner's Pay Account—check. Other advanced accounts we'll

discuss later in the book—all good. Now it was time to pay my bills from the Operating Expenses Account.

"What are you doing?" Debra asked, startling me.

I had no idea she was behind me, and I practically spit out my coffee. If you met Debra, you would never guess that she is a fully trained super-ninja or something. But she must be, because she has an ability to just appear next to you without you noticing. My tip? Avoid drinking any form of liquid when she's around; you will either gag on it or spit it all over the table when you look up and see super-ninja Debra clinging to the ceiling above you.

"I'm paying my bills," I replied.

"Why are you paying them today?"

Confused, I replied, "Um. . . because I have time, and they're due."

Debra said, "Well, that's not smart." (Ninjas don't mince words.)

"What do you mean?" I asked.

That's when Debra taught me the 10th and 25th cash flow rhythm—paying expenses twice a month, on the 10th and 25th. And that was the day the 10/25 Rhythm became integral to Profit First. Thanks, Debra! (If that is your real name.)

I implemented the process in my business immediately. I let the bills come in, and I deposited income, but that was it. I no longer did accounting when I had time, or when someone called to check and see if I'd received an invoice. I got into a rhythm. I did my accounting every 10th and 25th (or the business day prior, if the 10th or 25th fell on a weekend or holiday). I chose those days so my payments arrive by the 15th and the end of the month, when most bills are due. For our benefit we want to get into a rhythm of twice a month, and for our vendors benefit we want to make sure we pay them on time.

First, I tallied all the new deposits that had gone in over the last few weeks and did the Profit First allocations, moving money into each account. Then I tallied up all the bills and put them in the system.

A little bit of magic started to happen. I became less and less reactive about bills. I didn't immediately look at the bank account when I got a big bill and wonder why I spent so much, and when I could pay this one off. Instead I started to feel more in control. By

looking at my bills and my deposits two times a month, on the same days each time, I could see a pattern. I noticed that 80% of my bills were due at the beginning of the month, and that few were due in the second half. And I saw how my deposits were pretty equally dispersed over the month.

I realized that I had many "small" recurring bills that added up to a lot of money and were unnecessary expenses. I started to see trends and understand my cash flow. I didn't start to stack bills, paying what I could and then putting the ones I didn't pay back in a stack. I started to manage bills and cancel unnecessary stuff. I started to pay bills on time. Every bill.

Liz Dobrinska, my graphics guru who designed my website and even the cover of this book, told me, "I don't know what happened, Mike, but you now pay on time every time. I wish all my customers were like you."

Before I started following Debra's advice, I paid Liz inconsistently. Sometimes I paid the bill the day it arrived. At other times, I sat on it for sixty or ninety days. It wasn't because I was trying to take advantage of her; I was simply in reactionary mode. My method of bookkeeping was not an effective way to understand my cash flow or to keep my critically important vendors happy. The 10/25 Rhythm changed all that.

Here's how to get started:

1. Deposit all revenue into your Operating Expenses Account.

2. Every 10th and 25th day of the month, transfer the total deposits from the prior two weeks to each of your "small plate" accounts based on your current allocation percentages. For example, let's say you have $10,000 in total deposits for the past two weeks. Based on the following example percentages, here's how you would allocate the $10,000:

   Operating Expenses 43% - $4,300
   Tax 15% - $1,500

Owner's Pay 30% - $3,000
Profit 12% - $1,200
Employee Pay ($750) - $0
Petty Cash ($50) - $0

3. Transfer the specific dollar amounts from the Operating Expenses Account to respective accounts. In this example, Employee Pay for $750 and Petty Cash for $50. The accounts will now look like:
   Operating Expenses 43% - $3,500
   Tax 15% - $1,500
   Owner's Pay 30% - $3,000
   Profit 12% - $1,200
   Employee Pay ($750) - $750
   Petty Cash ($50) - $50

4. Transfer the full account balances for both your Tax and Profit Accounts to the respective "no temptation" accounts at your second bank.

5. You have $3,000 in the Owner's Pay Account from which to pay yourself. Take only what you have allocated as your bi-weekly salary, and leave the rest to accumulate. For this example, we'll say your bi-weekly salary is $2,750. This would leave $250 in the account.

6. Pay your employees from the Employee Pay Account. For example, if you pay $675 this pay period, it would leave $75 in the account.

7. With the remaining $3,500 in the Operating Expenses Account, pay your bills.

Once you've done all that, the accounts would look like this:
Operating Expenses 43% - $50

Tax 15% - $0
Owner's Pay 30% - $250
Profit 12% - $0
Employee Pay ($750) - $75
Petty Cash ($50) - $50

Profit and Tax money will be accumulating at your "no temptation" second bank. As new deposits come in, you will deposit them in the Operating Expenses Account, and on every future 10th and 25th you will repeat these same seven steps.

A big note here: There is a strong possibility that you will not have enough money in your accounts to do all this. If so, you've got a major wake-up call. When you don't have enough money left over to pay your bills, it is your business screaming at the top of its lungs, warning you that you can't afford the bills you are incurring. You are spending more money than your business can support. But don't panic. Later in the book I detail a process that will help you adjust to the 10/25 Rhythm as comfortably as possible. Even if you can't pay everything on the 10th and 25th, you must get into this rhythm, because it will allow you to get a sense for the flow and accumulation of money. A heart fills with blood and pumps it out, forming a heartbeat. The lifeblood of your business is money; it should flow in a rhythm like a heart, not in a random, panicked pump here and there when you have money.

QUARTER ONE

QUARTERLY DISTRIBUTION

The new quarter has arrived. Yippee! You are about to take your very first ever quarterly distribution check. That's right, baby. Your business is serving *you,* now. You are going to take a distribution check every quarter. Every ninety days, profit will be shared to you. This is where your Frankenstein monster starts to become a powerful, lovable beast and serves you a fine meal on a silver platter with a perfectly matched California Pinot Noir. Don't you just want to pinch those chubby cheeks?

The quarters of every year are as follows:

Quarter 1 – Jan 1 to March 31
Quarter 2 – April 1 to June 30
Quarter 3 – July 1 to September 31
Quarter 4 – Oct 1 to December 31

(This assumes your fiscal year is the same as the calendar year. If you have a funky fiscal year, like if your year-end is May 31st, then your quarters will be different.)

On the first day of each new quarter (or the first business day after), you will take a profit distribution. Remember, the Profit Account serves a few purposes:

1. Cash reserves.
2. Metric to measure growth.
3. Profit.

Tally the total amount of profit in the account (don't add any quarterly distributions percentages from deposits you received this day, yet) and take 50% of the money as profit. The other half remains in the account, as a reserve.

No matter what day you start doing Profit First, take a distribution for the current quarter on the first day of the new quarter. For example, let's say you decide to implement Profit First on August 12th. You allocate to your multiple accounts from that day forward. Then, on October 1st, or the first day of the new quarter that you do your bookkeeping, you distribute the profit in the Profit Account. Whether you start this process on July 3rd or September 31st, the next quarter still begins as of October 1st; so you distribute profits for the prior quarter that day. It doesn't matter when you start doing Profit First; what matters is that you get into a quarterly rhythm.

Welcome to the big leagues. You will now take a distribution every quarter, just like large public companies do. They announce their quarterly income and then distribute a portion of the profits to shareholders. And that's exactly what you are going to do (see, you are all grown up now). Quarterly is a great rhythm, by the

way. It is a long enough time between distributions that you start looking forward to them, anticipating them. But it isn't so frequent that they come to feel like a normal part of your personal income.

Every quarter, you will take 50% of what is in the account, and leave 50% alone. For example, let's say you have saved $5000 in your Profit Account during the first quarter of implementing Profit First. On the first day of the new quarter, you will take $2500 as a distribution to the equity owners and leave the other 50% intact.

If your company has multiple owners, the distributed profit is divided up based on the percentage owned by each equity owner. Following the above scenario, if you own 60% of the company, another partner owns 35% and an angel investor owns 5%, the distribution would be $1500 (for you, the 60% owner), $875 (for the 35% guy) and $125 (for the investor).

The key is this: The profit distribution may *never* go back to the company. You can't use a fancy term like "plowback" or "profit retention." No term you use will cover up the fact that you are stealing from Paul to pay Peter.

Your business must run on the money it generates for its operating expenses. The plowback of profits means you aren't operating efficiently enough to run on the operating expenses. And if you give the profit back, you won't experience the very important reward of your company serving you. You'll just be letting the monster loose again. So always take your profit, every quarter, and use it for your own purposes. It's celebration time!

CELEBRATION TIME!

When you take your profit distribution, the money is only to be used for one purpose: for your personal benefit. Maybe you go out for a nice dinner with your family. Maybe you get that awesome new couch you have your eye on. Maybe you go on a dream vacation.

In the four years since Jorge and Jose started implementing Profit First in their business, they have taken several dream vacations—Bermuda, Europe, cruises—and have given those vacations to their loved ones as well. These guys know how to celebrate!

"Before we started using Profit First in our business, we were a little bit lost and wondered when the business would take off and improve our lifestyle," Jorge told me. "I don't think anyone wants to work just for the paycheck. You need more incentive. Now, at the end of the quarter, we really look forward to planning what we're going to do with the extra money."

Whatever it is, you *must* use your profits on you! Why? Because this is how you turn Frankenstein, that cash-eating monster, into a cash cow that keeps giving to you and supporting you. Every quarter, with every profit you celebrate, you will fall more and more in love with your business.

PAY UNCLE SAM

Every quarter, you will also pay your quarterly estimated tax. Your accountant probably gave you estimates of how much you owe in taxes; now you pay them. You will reduce some of the pain you feel when paying estimates, because on this very same day each quarter, you also will take that profit for yourself, above and beyond your salary.

ONE SMALL STEP

Each quarter, you need to evaluate your current percentages and move them closer to your TAPs. You can move any percentage you choose to get to your TAPs, but know this—the goal is to never take a step back. I would much rather you take a small step closer to your target Profit Percentage than take a big leap toward it, only to step it back a month later.

If you are adjusting and tweaking your percentages conservatively, I suggest that you account for three percentage points each quarter. That is, you could move your Profit Account from 5% to 8%. Or you could move your Tax Account from 11% to 12%, your Profit Account from 5% to 6% and your Owner's Pay Account from 23% to 24%.

If you can adjust further, go for it, by all means. Just remember, you can't "undo your percentages," because that will undermine this new habit you have established. And don't forget: at the start of next quarter, you will be doing this all over again. Think about what

you're doing for a second. You are now distributing profits quarterly, which forces you to find ways to operate more efficiently. Isn't that friggin' cool? Your little company is now doing the same thing as the big kahunas in the industry. While Bloomberg Radio babbles on about "higher than expected" quarterly profits and shareholder distribution by such-and-such public company, you can smile and feel pity for the public stock shareholders and the measly portions they get because *you* own *a lot* of stock in your company. Oh man, does that feel good.

YEAR ONE

FINALIZE YOUR TAXES

Since you're in the quarterly rhythm of evaluating and moving closer to your TAPs, celebrating your profit disbursement and reassessing your expenses, there isn't much of anything special you need to do on a yearly basis. The only thing you need to add to your financial management at year-end is the finalization of your taxes.

Determine how much you owe and how far off you were in your estimates. If you owe more than you have in your tax account, a few things likely went wrong. You probably didn't save a big enough percentage in your tax account, and/or you didn't check in quarterly with your accountant to see how you were doing throughout the year with your tax reserve.

If you owe taxes at year-end and don't have the money in your tax account, this is the one time you can pull from your Profit Account for a reason other than profit distribution. In fact, you have to. You won't go to jail if you don't have profits to distribute to the owners, but you will go to jail if you don't pay your taxes. In this instance, pull the money you have from your Tax Account and your Profit Account to pay the taxes. Then adjust percentages in your Tax Account to ensure you will have enough for the next year.

When you adjust your tax percentage, reduce your profit percentage by that amount. Yes, you are taking a hit on profits, but next quarter you will work on getting those profits up again. The key now is to make sure you are fully prepared for taxes.

If you have too much money left in your Tax Account, congratulations—you can move that money to your Profit Account and take a profit distribution. You may also be able to reduce your Tax TAP and increase your profit allocation percentage by that amount. Just check with your financial expert first.

RAINY DAY FUND

As your profits accumulate in your Profit Account, and you only take half as a profit distribution, the remainder will act as a rainy day fund. You sort of become your own bank. This is a good thing, but too much cash on hand can be a liability (people like to sue deep pockets); and money should be invested, not allowed to sit and stagnate month after month and year after year. This is a simple analysis of what to do with your rainy day fund. First accumulate a three-month cash reserve for your business, so you have enough cash saved to operate unscathed for three months if all sales came to a screeching halt and not another penny came into the business. Then, when you see that the money in your Profit Account is in excess of a three-month reserve, you know this is a good opportunity to put money back into the business, to make some appropriate capital investments that will bring a lot more growth and a lot more profit, or to fund The Vault Account (that's a little teaser for what you will be learning in a little bit).

FOREVER

The Instant Assessment gave you the TAPs, but you can do better. Like an athlete assessing her performance over time, as you use the Profit First system, you will get a good sense of when and where you can push aspects of your business to the next, world-class level. If you can, push for 22% profit, or higher, or cut expenses down to 15%.

Even with you, and all the financial folks who help you in your business, following Profit First, you're still not finished. You can get every single person in your business, regardless of what they do, supporting the business with Profit First. They will do it by implementing a new type of to-do list.

In my second book, *The Pumpkin Plan,* I explain colossal seed-to-business growth—the intersection of uniqueness, top customer demand and systems. Your uniqueness (unique offering) is what makes money, but that only happens when your top customers want your offering. If you can deliver it to them on automatic, you have the potential to become a colossal force in your industry. These three factors form a new, better way to create and maintain a to-do list. You will use three symbols: a $ (dollar sign), a ☺ (smiley face) and an ∞ (infinity symbol).

From today forward, your team can quickly determine their most profitable tasks. If something will likely make money for the company within the next sixty days, give it a $. If it is something for a top client, give it a smiley face ☺; and if it is a system that can be created so that other people or things can do the task perfectly and you no longer need to do it, give it a ∞.

TYPE	PRIORITY	DEFINITION
$ ☺ ∞	1	Create a repeatable system that will make money in the next 60 days by serving a client (e.g. a website design that can be a template for many future clients' sites)
$ ☺	2	Generate revenue in the next 60 days from an existing client (e.g. a sales quote for an existing client)
$ ∞	3	Generate revenue from new clients and result in a repeatable system (e.g. a new product launch)
☺ ∞	4	Cater to clients and result in a repeatable system, but not generate money directly (e.g. implementing project management software)
$	5	Generate revenue within the next 60 days (e.g. a sales quote for a prospect)
☺	6	Serve an existing client, but won't directly result in revenue (e.g. modification to an existing contract at client's request)
∞	7	Create repeatable systems (e.g. form email responses to common questions)
(blank)	8	Though relevant and possibly important, won't generate revenue in the next 60 days, don't serve an existing client and won't create a repeatable system

Figure 6. Task Management List

Next, write down the tasks you have. Code each of them with no symbol (if it doesn't apply to the three categories above), or one of the symbols above. In some cases, a task will get two symbols or all three. Then prioritize your to-do list based upon the symbols in this order:

First do $ ☺ ∞ These are God's gifts to tasks. When you do one of these, you will make money, make a client happy (which, by the way, is the most powerful form of marketing) and systematize the task as a repeatable process. That way, the next time this task presents itself, you just hand it off and it will be done perfectly! Profit with a client loving it, *and* you will be able to do this on automatic going forward.

Next is $ ☺ Happy client paying you money = a happy life.

Then $ ∞ This is a task that lets you make money *and* develop a system to make it happen automatically. Maybe not for the current client, but automatic money usually means new clients down the road.

Then do ☺∞ This is a task that makes a client happy. You will develop a system so that it happens on automatic. Consider it automatic client retention and automatic marketing.

Then do $ This task means you are bringing in money. Profit, baby!

Next, do ☺ You might not make money immediately by performing this task, but a happy client is key to sustainability, is powerful marketing and usually leads to more money in the future.

Then do ∞ With this task, you build a system so that you don't have to do it anew every time.

And lastly, do " " That is a blank. I just put the air quotes there so you could see it was blank. In many cases, as you think of tasks and write them down, you will notice that most are blanks—they don't or won't make money in the near future, they don't serve clients and they aren't building systems. Do these things last.

By having everyone at your company prioritize their to-do lists with this simple system, you push Profit First. Don't just give this to-do system to a few people. Share it with your entire staff. Help them focus on the three things that matter most: profit (the lifeblood of

your business, without which you can't sustain the business), clients (the real boss; without them there is no business); and systems (the only way you can grow and compete).

• • •

Jorge and Jose are living the American dream. Just ask them—they'll tell you they are most definitely living the life they set out to experience when they first opened the doors of Specialized ECU Repair. If you follow the steps outlined in this book, you too will look back on your first Profit First year with awe and appreciation. You'll be living the dream, baby!

ACTION STEPS

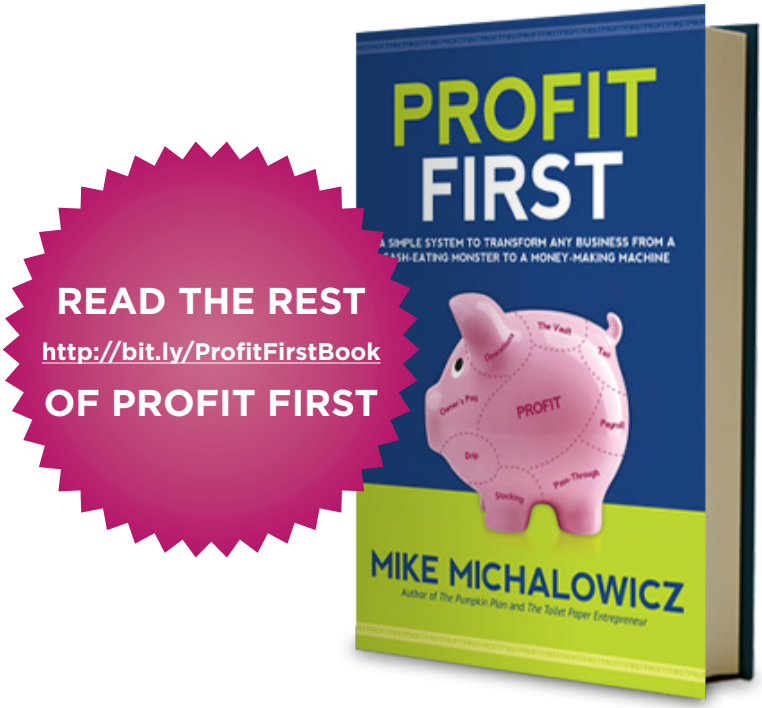
GET READY FOR A GREAT YEAR

Step 1: Go back to the beginning of the chapter and complete all of the "Day One" tasks outlined there: notify your accountant, set up your accounts (if you haven't done so already), and make your first Profit Account deposit or transfer.

Step 2: Start a "celebration list": come up with ideas for how you to spend your quarterly owner's distribution. Include small treats and big indulgences. Post the list where you can see it, for inspiration and motivation and as a reminder when the quarter comes around and you convince yourself there are more practical uses for the money.

Step 3: Based on the system I shared in this chapter, revamp your to-do list and start using it immediately. You can download blank Profit First To-Do forms at—you guessed it—the Resources tab at MikeMichalowicz.com.

Now that you started reading the book...master *Profit First* by reading the rest!



You are about to master the profoundly simple yet shockingly effective accounting plug-in that will transform your business from a cash-eating monster into a money-making machine. In *Profit First*, Mike Michalowicz, author of *The Pumpkin Plan* & *The Toilet Paper Entrepreneur*, explains why the GAAP accounting method is contrary to human nature, trapping entrepreneurs in the panic-driven cycle of operating check-to-check and reveals why this new method is the easiest and smartest way to ensure your business becomes wildly (and permanently) profitable from your very next deposit forward.

EXCLUSIVELY AVAILABLE AT: amazon.com®

Enter http://bit.ly/ProfitFirstBook into your browser to learn more about the book.