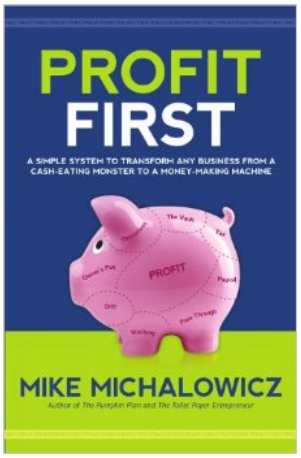
Business Book Review – Profit First



Mike Michalowicz Bio: Serial Entrepreneur who's started his first business at age 21, where he struggled a lot. Outwardly successful, it was non-stop work and little money coming to the bottom line. That's when he discovered many of the principles behind the Pumpkin Plan. Since that point he's sold two successful businesses and started several more…that's also when he learned that growth doesn't mean anything unless you're able to actually keep what you make. Profit First is his 3rd book. Mike also does a lot of speaking and writing.

Approach and Purpose

Approach: A traumatic personal experience (basically losing a personal fortune through bad habits) and the subsequent wake-up call and development of a simple system led to this book. It's based on real world experiences with his own business and that of his clients.

Book's Purpose: To help business owners get control of their business. This is a straightforward (simple but not easy) explanation of why many business owners struggle with revenue, profit and how to really make money over time.

"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."

"Today is the day we make your business (and your life in the process) financially strong. Permanently."

Introduction: Pretty much every business owner out there is interested in growing their business. There is an inherent belief that Bigger is Better and if things are tight on the financial side, you should grow your way out of it. Revenue solves a lot of problems. Unfortunately, revenue also masks a lot of problems, when money is coming in easily most people won't worry about the details or even how much they are spending.

Michalowicz shares his personal story, after successfully selling 2 businesses for a strong profit he got sucked into a flashy lifestyle. He bought 3 cars on the same day including telling the salesman that he wanted 'the most expensive' Land Rover they had. From there, he jumped into Venture Capital and started funding businesses, many of which didn't deserve to be funded but he felt like he could will them to success. As you might guess, it ended badly and he lost over $500,000 of his own money, a much bigger chunk of investor money and every business he funded (except one) went completely under. He hit rock bottom the day he came home and had to tell his family that he had lost everything and that they were dead broke, meanwhile he still owned (and was paying on) the fancy cars, office, etc.

"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****."*

Challenges:

1. **Focus on Top Line Revenue** – it doesn't matter how big your business is, it matters how healthy it is and top line revenue can't tell you anything about health. In fact a bigger business that's not healthy is a much bigger risk.
2. **Human nature** – We're inherently wired to spend what we have, eat what's in front of us. When we make more money (revenue) we will spend more money, which doesn't leave anything for profits.

It all ties back to how we look at the game of business – the old business class equation is:

Sales – Expenses = Profits

Using this approach, this mindset means that **Profits are what is left over**...but human nature drives us to spend what's in front of us, therefore Expenses end up cancelling out Sales...often leaving us with no Profits. But what if you were to change the equation?

Sales – Profits = Expenses

Mathematically it's still the same equation but in terms of how you think and operate your business, it's vastly different. If you take your profit out first, then your expenses are now left over – forcing you to be creative and challenged on how to keep the doors open. The end result might be the same as you feel today but at least in this case you are taking money home.

Taming the Beast (Your Business is a Monster)

Like Dr. Frankenstein, you brought your creation (your business) to life with nothing more than imagination and hard work. At first it was a miraculous thing that you created...but as it grew, it became stronger and hungrier. It's hungry for your time, your hard work and mostly hungry for your money.

The answer isn't more growth. As long as you spend what you make, more isn't better. The bigger your monster gets, the more it takes to feed it. Payroll goes up, capital expenses, rent, marketing costs, things you need, things you may not need but think you need – all of it costs more and more money. So you scramble to sell and to collect just so you can cover this week's costs (and feed the monster).

That's when you fall into the Survival Trap. You get creative on how to find more money just to cover this month – but most of the time those efforts actually take you away from your long term vision, so next month you're even farther away from where you wanted to be then you were before.

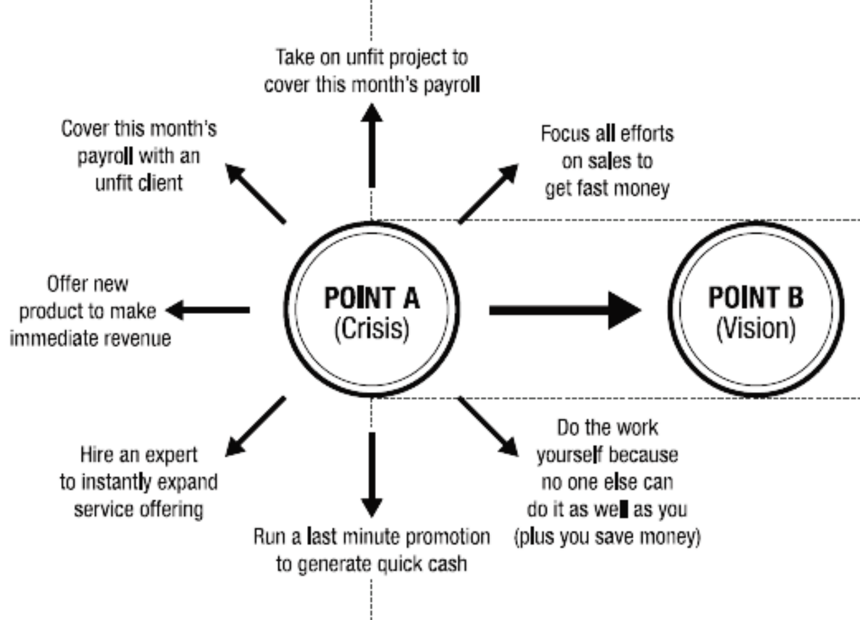


Figure 1: The Survival Trap

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How to escape the Survival Trap – How Profit First Works

Relatively recent studies have shown that people are eating more these days because plates are bigger than they were 30 years ago. We humans have a strong tendency to eat what we have in front of us so a simple answer to eating less? Use smaller plates.

As a business owner with cash in the bank, the premise is the same; if I have the cash readily available I'm likely to find a reason to spend it. Profit First is basically the idea of using smaller plates for your business, in essence tricking yourself that you have to make do with less money. It's basically the same idea that a 401K plan works under. When I take the money out up front, I don't notice that it's gone, so I don't miss it.

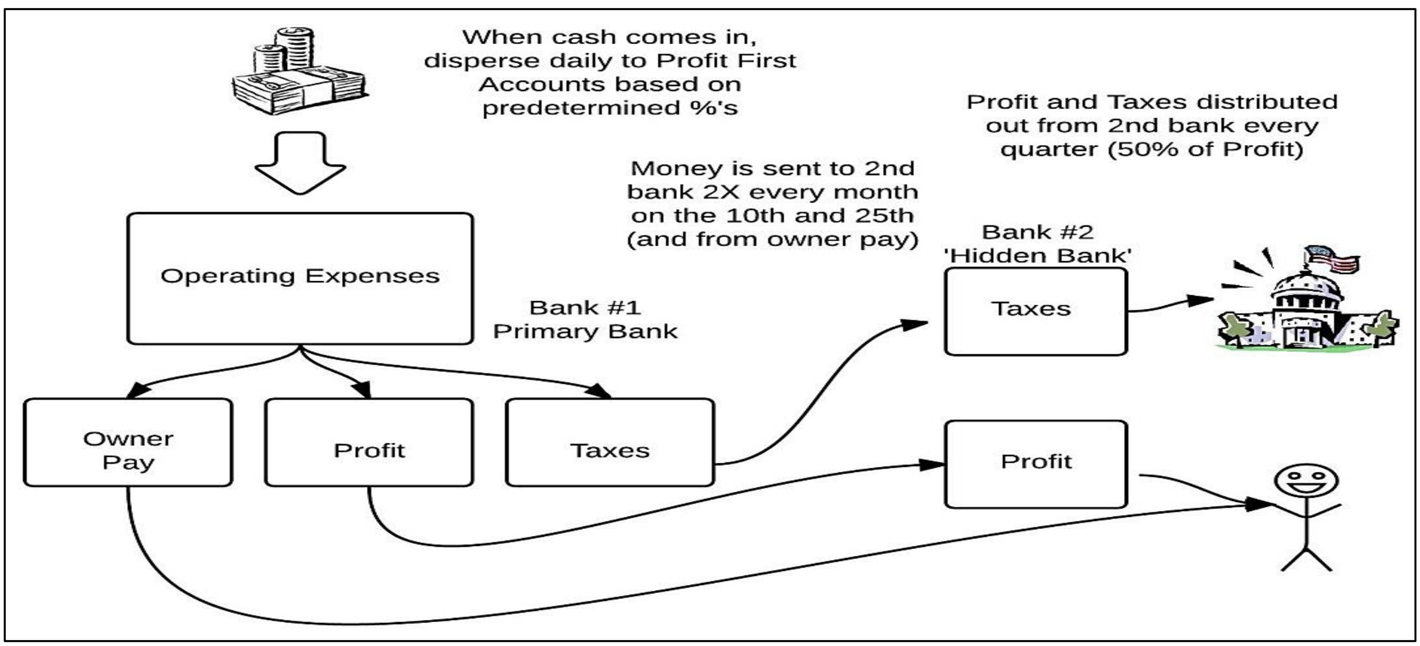
More than just small plates: In order to really make this work, you need a few additional ideas:

Small Plates – When money comes into your main account, immediately disburse it to other accounts based on pre-determined percentages. Other Accounts? (Profits, Owner's Pay, Taxes, Operating Expenses)

Serve Sequentially – Your Profit First account gets served first, then Owner's Pay, then Taxes and what remains is applied to your operating expenses. No exceptions – this is the heart of making it all work.

Remove Temptation: Make it difficult to get into your Profit First account, keep it out of sight (at a 2nd bank)

Enforce a Rhythm: Make this into a monthly habit – work your payable accounts 2X per month, on the 10th and the 25th so you can really start understanding how cash flows through your business.



How Healthy is Your Business?

Business owners tend to focus on how big their business is...or how fast it's growing. The reality is that growth or size doesn't mean anything if the owner isn't pulling money out of the business and keeping a fair share of it. It may be surprising to a lot of people, but many businesses run on the ragged edge, even award winning entrepreneurs (Michalowicz won awards) spend a lot of time trying to figure out how they're going to make ends meet every month. That's not healthy.

The Profit First Instant Assessment

The first step towards implementing Profit First in your business is to get a clear idea on where you stand right now, which is where the Profit First Assessment comes in. This is a quick overview of your business's financial health that you should be able to fill out with basic information on your own.

	Actual	PF%	PF$ (Calculate)	The Bleed	The Fix
Top Line Revenue	**1**				
Material & Subs	**2**				
Real Revenue	**3**	**100%**			
Profit	**4**	**PF% (P)**	PF% **x** R. Rev	**Actual – PF$**	**The Fix**
Owner's Pay	**5**	**PF% (OP)**	PF% **x** R. Rev	**Actual – PF$**	**The Fix**
Tax	**6**	**PF% (T)**	PF% **x** R. Rev	**Actual – PF$**	**The Fix**
Operating Expense	**7**	**PF% (OE)**	PF% **x** R. Rev	**Actual – PF$**	**The Fix**

1. Actual Top Line Revenue for the last 12 months – should be able to pull this directly from accounting.
2. Cost of materials...or the cost of subcontractors (not employees) used to deliver your product / service (if you don't have materials or sub-contractors, then this gets an N/A or stays blank)
3. Real Revenue – calculated by subtracting Materials & Subs from Top Line Revenue. Note – Real Revenue is important as a way to level set how big your business really is. Example – An advertising agency that has $10M in top line revenue, but $8M of that is pass through of advertising costs.
4. Actual profit from the last 12 months (either accumulated or distributed) – this should be money that's in addition to a reasonable salary for the work you do for the company.
5. Actual pay to yourself and any other owners for the last 12 months.
6. Actual money paid towards taxes in the last 12 months (or currently reserved for taxes).
7. Total expenses paid over the last 12 months (doesn't include profits, owner's pay, taxes, materials and subs...Basically it's everything else.

Note – when you add up your actual profit, owner's pay, tax and operating expense it should total your Real Revenue. If it doesn't, you've missed something and you need to fix it.

PF% - In the next column you're going to figure out the appropriate PF% from the Target Allocation Percentages table (below). These are suggested % based on average company revenue #'s.

PF$ - Calculate Profit First $ dollar amount by multiplying your Real Revenue times the PF% for each row.

Bleed – Subtract your PF$ amount from your Actual column for each category. A negative amount means you're bleeding money in that category (i.e. you're not claiming enough profit)

The Fix – final column is a simple increase or decrease indicating what you need to do to get the actuals in line with the PF$ dollar amount for each category. If the bleed is negative you would put increase.

That's it. A quick assessment that will tell you if you are taking out an appropriate amount of Profit and Owner's Pay (and taxes) for the size of business you have (in Real Revenue). The Target Allocation Percentages are based on experience and should be applicable across industries. They're not perfect, but a good starting point – it's also important to remember that the PF$ are your target...not necessarily where you are now.

Target Allocation Percentages (TAPs)

Real Rev. Range	$0 - $250K	$250K - $500K	$500K - $1M	$1M - $5M	$5M - $10M	$10M - $50M
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%**

Notice how the profit amount varies over the Revenue Ranges – starting out your expected profit is small, but your Owner's Pay % is fairly large. There's not as much money to go around...but since you're small you don't have a lot of employees at this point either so expenses should be lower. The $1M to $5M range is where the combined Profit and Owner's Pay drops to 20% - because at that size a business has to be investing in infrastructure and people in order to keep growing (plus with larger numbers you don't need as large of a % to take home significant money). Finally the Profit % is never very high – that's because the market will generally push you down (over time) if you're making extreme profit margins and 20% is very good for true profits.

Fill out your own Profit First Instant Assessment. How do you fare? Where does this make sense in your world...and where does it seem way off?

"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.****"*

Getting Started with Profit First

Now that you've taken the Instant Assessment, it's possible, if not likely that you are a long way off from your targeted Profit First amounts – you're not paying yourself enough and you don't have much profit to speak of right now.

What you DON'T want to do is immediately start withholding your target amounts – for a couple of reasons:

- You likely can't afford to make a big swing towards Owner's Pay and Profit without cutting costs...and it can take some time to cut costs without putting your business at risk.
- It's important to experience some success and positive momentum with your new approach...and a big change is much more likely to stall out or have to be backed out when an unexpected bill comes up.

Step 1 - Talk to your accountant. You need to get your accountant to buy into your overall plan...and there's a possibility that your accountant will fight you on the idea (it will require a bit of extra work on the accounting and money transfer side of things). If your accountant can't get on board, get a new accountant who can.

Step 2 - Set up your accounts: Set up your bank accounts as described previously. Create 4 accounts in your primary bank and 2 in a 2nd bank that will be out of sight and out of mind.

Step 3 – Start out easy: Determine what you've been contributing to your accounts (as best you can tell) and increase that by 1% to start with. So if you were taking 2% profit and your target is 20%, start by taking out 3% for now. If you didn't have any profit, start with 1%. The key is to get started and build up the habits.

Day One: Start with your primary account (your old business checking account, now your Operating Expenses account. From that total subtract any outstanding checks and payments and then disburse the remaining amounts based on your starting Target Allocation Percentages (from step 3 above). Ex. You have $5000 in your business account...and checks and outstanding bills of $3000 for this month. Multiply the remaining $2000 by your TAPs and move the appropriate amount of money to the other 3 accounts at your primary bank. As you get additional deposits in, they'll get shifted in the same way (for now – soon you'll start doing this just 2X a month).

Slice Your Expenses: The best way to drive up your profitability is by cutting your expenses. If you have a profit margin of 10%, it would take $1000 of additional sales to get $100 in profits. Or...you could just cut $100 in expenses. It's not easy and you will have to give up some things, but it's likely that it has to be done. Let's imagine that you need to cut expenses by 3% to hit your new targets. Then you should try to cut your expenses by at least 10% RIGHT NOW in order to give yourself room for growth (and to build up some cash).

Monthly Rhythm: Block time on your calendar and start doing all of your accounting on the 10th and the 25th of each month. All deposits that come in will get divvied up at the time and all bills will be paid at that time as well. This schedule will help you get better visibility to where you money is coming and going (since you're seeing it all at once) and it will help you be more in control of the whole process. At this point you also need to transfer your money from Bank 1 Profit and Tax to Bank 2 Profit and Tax.

Quarterly Distribution: At the end of the quarter do the following:

- Cut the quarterly distribution checks. Take 50% of the money that's in your Bank 2 Profit account and write a check to your personal account! It's only 50% because that Profit account also acts as a cash reserve. One rule – that profit check NEVER goes back into the business. Your business must run on the money it generates. Use your new profit to celebrate or do whatever.
- Pay your quarterly estimated taxes out of your Bank 2 Tax account.
- Increase your Target Allocation Percentages by 1% (unless you are at your target)

Annually – the only difference at the end of the year vs. end of quarter is that you need to finalize your taxes. If it turns out that you owe more in taxes than you've allocated, then you need to make up the difference from your Profit account – but you must adjust your TAP up for taxes and down for profits to make sure it's right going forward. If you have tax money left over, you can move that into your Profit account.

Keys to Success

- **Your mindset:** If you really want to lose weight and keep it off, it requires more than a temporary diet change...it requires you to adopt a healthy lifestyle. That's what Profit First is really about. You have to go into with the idea that you are fundamentally approaching your business differently.
- **Cut Debt and Expenses:** You have to get your costs under control which may require extraordinary efforts at first. You may have to lay off employees, get rid of services and re-negotiate for better pricing. But if you don't get your costs under control, you will not generate a profit...and you can't just 'grow your way' out of it. Learn to enjoy a cost-cutting, frugal mindset.

- **Create efficiency:** Find a way to make things as repeatable and systematized as possible. Challenge yourself to get 2X the results with ½ the costs. By thinking big, you're more likely to uncover a breakthrough in efficiency vs. saving just a little bit of time here and there.
- **Get some Accountability:** It will be difficult to build up new habits and exceptionally easy to fall back into bad, old habits. One proven way to mitigate that risk is find someone to help hold you accountable. That could be a coach, a peer group or a partner.

Advanced Profit First Techniques

You have to walk before you run...and it will take a while for these new ideas and habits to soak in, but after a year or two of success, it may make sense to try some more advanced ideas. They don't really change the concept, but they do add some twists.

- Additional accounts – add an Income Account to better understand the money coming in, Add a 'Vault' account as an emergency fund and build up a 3 month reserve, a 'Big Purchase' account – start allocating money for big purchases well in advance to minimize impact.
- Focus on what you want to make (Pay and Profit) and engineer what you need to make that happen
- Build on maximizing profits (rather than growing revenue); if you adopt this kind of focus you'll likely make different decisions in terms of priorities, clients, spending, etc.

Parkinson's Law

Profit First is driven by Parkinson's Law, which states that resources expand to fill the space available. If you have $100 to pull off an event, you'll spend $100. If you have $1000, you'll spend $1000. That's not to say that you shouldn't spend what you NEED to spend – just make sure it's a need and not a want.

Conclusion:

Far too many businesses are focused on top line growth and revenue and not on being a healthy business (with significant profits). You have to focus on having a healthy business first.

The only reason your business exists is to give you what you want out of life. Your business is here to serve you and if that's not happening today then you need to make some changes or close it down.

You will fall into the 'Survival' trap of scrambling for more revenue and increasing your debt if you don't have plans and system in place to keep things under control.