

# PROFIT FIRST

Transform Your Business from a Cash-Eating Monster to a Money-Making Machine

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## The Big “So What”

Money is the foundation of any business. Without money, you can't deliver your solutions, spread your message, create an impact or gain your financial freedom. **Whether you're starting a new business or improving an existing one, Profit First can help you to grow an efficient, profitable business to deliver more results with less effort.**

## Why Profit First?

At least 50% of businesses fail in the first 5 years, and many more continue to hover on the brink of collapse. Entrepreneurs may start a business to do what they love and gain financial freedom, but end up as slaves to their businesses. They work hard, put in their life savings and chalk up debts to keep the business afloat; yet they don't make money.

**Profit First is built on this simple idea: Before you pay your expenses, take your profit first.** Run your business based on what you can afford *now*, not what you hope you can afford someday.

- The concept may be simple, but it requires that you (i) unlearn what you've learnt about business and accounting, (ii) fundamentally change the way you think and do things, and (iii) face up to the hard facts so you can fix them.
- If you apply Profit First to a new business, you can make profits from day one. If you've been losing money for years and can't even pay yourself a salary, then it's time to transform your business. Michalowicz initially developed Profit First to address his own financial woes. He found it to be so effective that he started to test and refine it with a range of businesses. Profit First has helped tens of thousands of businesses since 2014.

## KEY QUOTES

*“If you need to make your first profit or just need to amplify the profits you already have, (Profit First) is the path.”*

*“Putting your nose to the grindstone is a really easy way to cover up an unhealthy business.”*

*“Most entrepreneurs are just covering their monthly nut (or worse) and accumulating massive debt.”*

*“I am here to eradicate entrepreneurial poverty.”*



## Grow a profitable business, not a cash-eating monster



Remove these 2 misconceptions which can kill your business.

- Bigger ≠ better. Don't measure business success using size or rate of growth. Growth is only good if it's healthy growth. If you put every cent toward growing a business in hope of eventually landing a big deal and becoming profitable, you're just creating an out-of-control cash-eating monster. Reverse-engineer your business, using profitability to define your ideal business size. Get profitable *before* you grow.
- Income ≠ cash and cash is king. Entrepreneurs tend to focus on income instead of cash-flow, on making money instead of taking profit. When sales increase, they assume it's the new norm and start to spend more (e.g. hire staff, buy equipment). When sales dip, they find it hard to reverse their spending habits and rush to find other ways to make money—they take on *any* sale (regardless of whether it's profitable) or borrow money to cover the shortage. In the process, they chalk up more expenses and debt to worsen the cycle of unprofitability and cash-shortage.



Beware of the "survival trap".

- Every sale comes with financial costs (e.g. advertisements, labor) and opportunity costs (i.e. what else you could've done with the same resource). When you spend more than you can afford, you find yourself with a cash shortage. You start to grab any sale, client or project to bring in cash, without considering the opportunity cost, business-fit or profitability. The more you widen your product range, the less efficient you become.
- Let's imagine you want to build a successful plumbing business. Along the way, you take on other jobs (e.g. lawn mowing, cleaning) to earn more money. With each new job, you buy new materials/equipment, thinking you can recover the cost from future jobs. The more you "invest", the more random jobs you take on to cover the cash-deficit and the less efficient you become in each area. You find yourself constantly stuck in a crisis mode and lose sight of your original business vision.

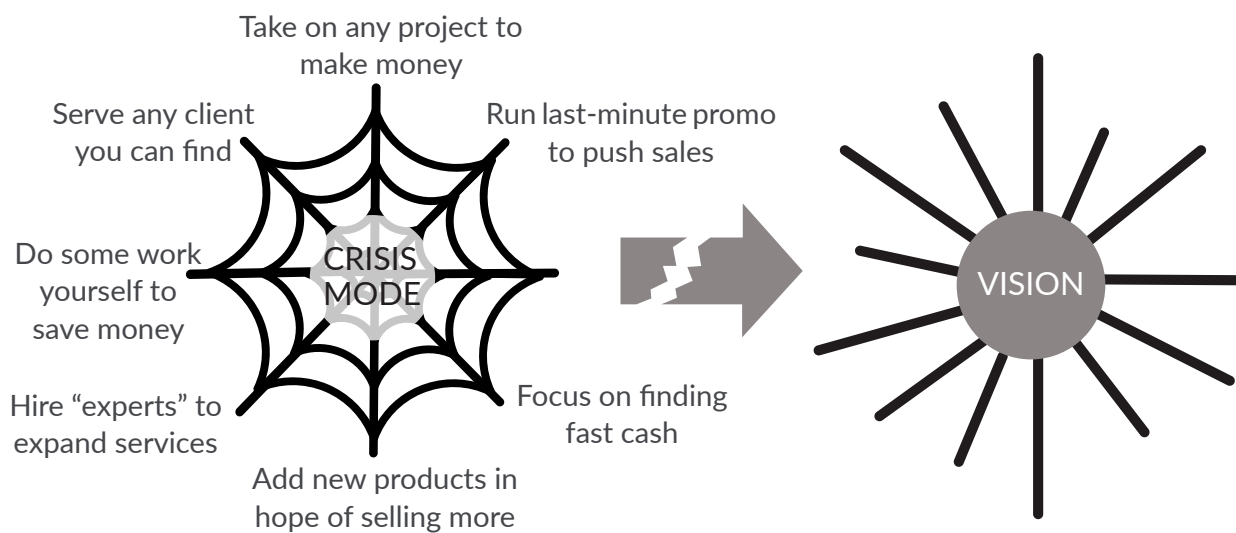


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### KEY QUOTES

*"You need to fix profit first,  
then grow."*

*"Sustained profitability  
depends on efficiency. You  
can't become efficient in crisis."*



## KEY QUOTES

*"The Survival Trap promises fast money, 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."*

*"When you're waiting for the leftovers, at best you'll get scraps."*

*"No more leftovers for you—it's time for you to eat first."*

*"The more we have of something, the more of it we consume."*



### Change your accounting formula.

- Traditional accounting practices worsen the problem. Generally Accepted Accounting Principles (GAAP) are based on this formula:  $\text{Sales} - \text{Expenses} = \text{Profit}$ . You focus on sales and expenses, before assigning the "leftovers" as compensation for owners, taxes and profits. Accounting profits are just paper profits which may not translate into cash in the bank; often the money is already "ploughed back" for future growth. GAAP also ignores how efficient you are in generating and retaining your sales revenues.
- Change your accounting formula to this:  $\text{Sales} - \text{Profit} = \text{Expenses}$ . Take your profit first so you'll be forced to spend *only* what you can afford. Make profit your focus, not an afterthought.



### **Profit First: The 4 Core Principles**

To transform your business into a money-making machine, you must develop sound financial habits, just like how you need healthy dietary habits to lose weight. **The Profit First system is tailored based on 4 principles from dietary-science research.**



Use small plates. We tend to consume all the food on our plate. Simply by using a smaller plate, you can reduce your food intake.

- The Parkinson's Law says that demand expands to match supply. If you have a one-week deadline for a project, you'll take the full week to finish it; but if you have only 1 day, you'll find creative ways to get the same project done in much less time.



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## KEY QUOTES

*"When less money is available to run your business, you will find ways to get the same or better results with less."*

*"When profit comes first, it is the focus, and it is never forgotten."*

- When you put all your money in 1 account, you feel richer and spend more. Reduce the amount of available cash so you're forced to be smarter and more innovative with how you use each cent. Later, we'll explain how you can do that by (i) taking your profit first and (ii) splitting the remaining amount into smaller accounts.



**Change your meal sequence.** Consume nutritious, low-calorie food (e.g. vegetables) first so you'll be full by the time you get to the less healthy options.

- The Primacy Effect says that we'll place more emphasis on the items we encounter first. The 2 sets of words below are likely to trigger different emotional responses in you, even though they're the same words presented in reverse order.

(i) Hate, Anger, Bad, Good, Joy, Love

(ii) Love, Joy, Good, Bad, Anger, Hate

- Later, we'll explain how to allocate your business income into sub-accounts in this sequence: Income → Profit → Owners' Pay → Tax → Operating Expenses (Opex). Always take profits first and pay your bills last.



**Remove temptations.** It's human nature to seek convenience. To cut down on junk food, remove them from the house and stock up on healthy food instead. Likewise, once you've taken your profit, keep it out of sight and out of mind so you won't be tempted to use it for your business.



**Build a Rhythm.** Eat small, regular meals so you won't get hungry and over-eat. Likewise, don't wait for your monthly or annual statements to assess your cash position.

- Take a few seconds daily to log in and check your bank balance.
- Do your income allocations and pay your bills bi-monthly on the 10<sup>th</sup> and 25<sup>th</sup> of each month.

## Implementing Profit First



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### Set up your accounts



Set up 5 foundational accounts: INCOME, PROFIT, OWNERS' PAY, TAX, and OPEX. Go for checking accounts as the convenience will outweigh any interest you can get from savings accounts. You can rename your existing company account to "OPEX" as you're likely to pay your bills from that account. Direct all your revenue deposits into a new INCOME account.



Then, set up 2 "no-temptation accounts" with a separate bank: PROFIT-HOLD and TAX-HOLD. Go for savings accounts, since the money won't be moved regularly and you can earn interest on it. Link these accounts to your PROFIT and TAX accounts so you can transfer money. Disable the "convenience" options (e.g. no online banking, check-books or debit cards), so you force yourself keep them out of sight and out of mind.



### Tips:

- Selecting your banks. For your 5 foundational accounts, choose a bank that provides easy access to view your accounts and transfer money between the 5 accounts. For your no-temptation bank, choose one that will make it hard for you to withdraw the money (e.g. only if you go down in person and withdraw for the right reasons). Negotiate with the banks for waivers of minimum balance requirement or transaction fees etc. If your bank is inflexible, find another bank that'll meet your needs.
- This approach is similar to how people manage their personal finances by having different envelopes for different expenses (e.g. mortgage, travel, food, fun, emergency). Each account is like an envelope: all it takes is a quick glance to know how much you have. You want all 5 foundational accounts in 1 bank to ensure the transfers are instantaneous so you'll have real-time updates of your balances.

## KEY QUOTES



## ? Common concerns:

- Isn't growth important too? Taking profits first doesn't mean you can't grow. It just forces you to be more selective with your investments, so you'll focus on your most profitable niches and grow *only* in areas that make money.
- But I've never been profitable. It may seem strange to take profit if you've always been unprofitable. Trust the process—by taking profit first, you'll change how you do business to become profitable.
- Can't I do this on a spreadsheet? It takes the same effort to track your finances using bank accounts or a spreadsheet. However, bank accounts are much more accurate and visceral. Just take 1 hour to set the accounts up; don't overthink it.



## Assess your Business Health

Do the exercise below to gauge the health of your business, so you know where you stand and how to improve. You can download the form from [MikeMichalowicz.com](http://MikeMichalowicz.com).



**Prepare for the Instant Assessment.** Gather your (i) Profit and Loss (P&L) statement from your last full business year, (ii) tax returns from each business owner for the same tax period, and (iii) balance sheet as at the end of that year.



## Fill in the table below:

	ACTUAL	TAP	PF\$	DELTA	FIX
Top-Line Revenue	(a)				
Materials	(b)				
Real Revenue	(c)	(h)	(m)		
Profit	(d)	(i)	(n)	(r)	(v)
Owners' Pay	(e)	(j)	(o)	(s)	(w)
Tax	(f)	(k)	(p)	(t)	(x)
Operating Expenses (Opex)	(g)	(l)	(q)	(u)	(y)

Table 1: Instant Assessment Form



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## KEY QUOTES

*"If you don't change the way you take your profit, you will never take a profit."*

*"A financially healthy company is a result of a series of small daily financial wins, not one big moment."*



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## KEY QUOTES

- (a) Enter your top-line revenue or total sales for the last 12 months.
- (b) Enter only the cost of raw materials. Include the cost of subcontractors and agents but exclude all staff salaries. If you're unsure, just leave it this as \$0; don't overthink it
- (c) Deduct (b) from (a) to get the real revenue your company actually made. This is different from Cost of Goods Sold or Gross Profit because it excludes the cost of labor.
- (d) Enter your actual profit from the last 12 months—this must be real profits (cash retained or distributed), not paper profits.
- (e) Enter how much owners' pay was given to all business owners. Include only regular payments, not profit distribution.
- (f) Enter the amount of taxes paid by the company on the owners' behalf (i.e. the income tax for owners, not the company's own tax). This is likely to be \$0.
- (g) Add up the opex for the last 12 months, i.e. everything else you paid except for the items above. Check that (c) = (d)+(e)+(f)+(g).
- (h)-(l): Enter the Target Allocation Percentages (TAP) or desired allocation. You can use the numbers in Table 2 for a start.

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%	17%
Owners' Pay	50%	35%	20%	10%	5%	3%
Tax	15%	15%	15%	15%	15%	15%
Opex	30%	40%	50%	65%	65%	65%

Table 2: Target Allocation Percentages (TAP)

- (m)-(q): Copy your Real Revenue [cell (c)] into cell (m), then calculate the remaining PF\$ cells by multiplying (m) with the TAP percentages



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*"Denial is a wonderful thing; it lets you ignore reality until reality punches you in the face."*

*"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."*

*"Making yourself the sacrificial lamb does not promote efficiency; it hinders it."*

(r)-(u): Deduct the actual numbers [cells (d) to (g)] from PF\$ [cells (n) to (q)] to get the Delta numbers. Negative numbers mean you're losing money in those areas.

(v)-(y): Indicate "increase" or "decrease" to reflect what you must do to fix the gap. For example, if opex is too high, then you'll need to cut expenses. Here's an example:

	ACTUAL	TAP	PF\$	DELTA	FIX
Top-Line Revenue	110K				
Materials	40K				
Real Revenue	70K	100%	70K		
Profit	0	5%	3.5K	-3.5K	↑
Owners' Pay	50K	50%	35K	15K	↓
Tax	6K	15%	10.5K	-4.5K	↑
Operating Expenses (Opex)	48K	30%	21K	27K	↓

Table 3: Instant Assessment Example



**Note:** The numbers will often turn out to be worse than expected. If you feel shocked or angry with yourself, know that this is the norm; you're not alone. The earlier you face the hard truths about your business, the earlier you can take steps to improve it.



## Define your Allocation Percentages



The Target Allocation Percentages (TAP) are the healthy numbers that you should work toward. The figures in Table 2 are not cast in stone—they're put together by Michalowicz based on his experience working with thousands of healthy companies in the USA. You can use those numbers to start implementing Profit First, then return to refine them later after you have a better grasp of the system.

- Profit TAP. To identify the best TAP for your company, you can research the profit percentages of 5 public companies in your industry or look at your best profit percentage in the last 3-5 years. Part of your profits will be periodically distributed to the owners while the remainder is kept as a contingency fund.






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## KEY QUOTES

*"Profit is not an event. Profit is a habit."*

*"Perfectionism kills every dream—better to just start."*

- Owners' Pay TAP. Many entrepreneurs pay their staff market rates but pay themselves low or no fees. Consider (i) the amount of work and value contributed by each owner and (ii) how much you'd reasonably pay someone to do those jobs.
- Tax TAP. To achieve financial freedom, you must design your finances such that your business will pay your personal income taxes. Work with your accountants to refine the TAP based on your local tax laws.

 Your Current Allocation Percentages (CAPs) reflect the current state of your business. **Your goal is to move from your CAPs to TAPs.**

- A successful, profitable business is created from a series of steps taken over time, not 1 big jump. Aim for modest improvements each quarter, e.g. increase Profit CAP by just 1 % (from 0% to 1%) or decrease Opex CAP by just 3% (from 84% to 81%). Go small so you'll minimize the resistance to act, build the right habits and progressively move toward your goals.
- Don't try to perfect the numbers. It's much better to get started and learn how the system works, then gradually adjust your numbers over time.



### Step-by-Step Process for Applying Profit First



#### Day One: Get started.

- Get buy-in from your people, especially your accountants. You can get them to read this book.
- Set up your accounts. For easy administration, name each account with both the CAP and TAP e.g. "PROFIT 7% (TAP 15%)". You can update the name/numbers anytime.
- Make your first distributions. Once you've set up your 5 core accounts, distribute the bank balance from the INCOME account to the other 4 accounts according to the CAPs you've set.
- Celebrate! You've taken your first steps to become profitable.



Week One: Cut expenses. You can get more money by increasing sales or decreasing expenses; it's much faster to cut expenses.

- List down all your expenses for the last 12 months, including recurring expenses like rent, internet access etc.
- Cut all items that're not essential for running your business efficiently or keeping customers happy. You can typically cut 10-20% of such expenses overnight, e.g. unnecessary office space or membership fees. Do *not* cut staff salary.



Twice a month (10<sup>th</sup> / 25<sup>th</sup>): Do your distributions and payables.

- Deposit all your revenues into the INCOME account. On the 10<sup>th</sup> and 25<sup>th</sup> of each month, (i) distribute the INCOME balance based on your CAPs, (ii) transfer the full amounts from the TAX and PROFIT accounts to the 2 no-temptation accounts, (iii) take your allocated bi-weekly salary from the OWNERS' PAY account and (iv) pay your bills from the OPEX account.
- If you don't have enough to pay yourself or your bills, it means you must make more changes to your business. The goal here is to create a rhythm so you can have a consolidated view of all your business components and can take regular, proactive action to manage them.



Quarter One: Profit Distribution and CAPs improvement.

- Profits are the rewards for investing in your business, whereas Owners' Pay is the compensation for your contributions. On the 1st day of each quarter, distribute 50% of the PROFIT account balance between the owners. Use the profit distribution to celebrate or do something you enjoy. Do not reinvest it back in the business. Keep the remaining 50% in the account as your rainy-day funds.
- At the end of each quarter, decide on the CAPs improvement for the next quarter. Michalowicz recommends no more than 3% improvement per quarter, so you'll always move forward (never backward).



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## KEY QUOTES

*"Small, repetitive, continuous actions, chained together, build momentous momentum."*

*"Profit is intended to be your reward for having the guts to invest in your own business."*



## Year One: TAX and PROFIT Payments

- At the end of the year, pay your taxes using the money you have set aside. Cover any shortfall using money from the PROFIT account; transfer any excess to the PROFIT account. Review your TAX TAP to minimize future gaps.
- If, after deducting the 50% profit distribution, you still have >3 months' cash reserve in your PROFIT account, you can consider investing the excess money back into your business e.g. as capital investments to improve future profitability and efficiency.



## Removing Debt and Freeing Up Cash in your Business



If you're heavily in debt with no cash reserves, you'll intuitively focus on repaying your debt. However, this only addresses the symptoms, not the root cause. The only way to remove debt permanently is to change your financial habits and become truly profitable.



Do a "Debt Freeze", i.e. don't take on any more new debts while you cut costs and remove your existing debts.

- Print out all statements related to debt and expenses. Go through every expense item (past and present) and group them into 3 categories: (i) "P" for items that're essential for profitability, (ii) "R" for essential items that can be replaced with cheaper options, and (iii) "U" for unnecessary items. Circle out all recurring expenses.
- Start cutting expenses. Every small saving adds up to create a massive impact on your bottomline.
  - (i) Cut all "U" items. If you're unsure, just cut the item first and add it back later if needed.
  - (ii) Negotiate all "R" items. Start with the smaller items to hone your negotiation skills, then work on the bigger items.
  - (iii) Stop automatic deductions except for "P" items. Manual payments will force you to evaluate each dollar being spent.



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*"Well-dressed poverty is still poverty. Just because your business is making lots of money doesn't mean you're hanging on to it."*

*"We are on a mission to change the perspective of successful business from 'make a lot' to 'save a lot'."*



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## KEY QUOTES

*"The goal here is to cut cost,  
not to compromise the  
business."*

*"Projections are an opinion.  
Cash is a fact."*

*"To tap into the river of profit  
flowing just under the surface  
of your company, you need to  
look at efficiency in every  
aspect of your business."*

*"Letting go of clients who suck  
us dry and eat up our profit  
margins is a way of making  
space for clients we can serve  
exceptionally well by doing  
what we do best and with  
fewer resources."*

(iv) Try to delay new purchases by another day or week to test if you really need it.

- Evaluate labor costs separately: examine each person on your team to decide if the role (not the person) is truly essential for the company. Restructure the work so people only cover "P" roles. If necessary, let people go but do not ask your staff to take a pay cut.
- Sum up your annual expenses (excluding taxes, owners' distributions and salaries) and divide it by 12 to identify the amount to set aside on average per month. Compare that with the Opex TAP in your Instant Assessment and aim to reduce your expenses to 10% below that figure (i.e. TAP-minus-10%).
- Use the bulk of your profit allocation to clear your debt, keeping a small amount to reward yourself. Pay off the smallest debt first—this frees up recurring payments that'll go toward paying the next-largest debt.



You can always find innovative ways to improve your efficiency.

- Throw out myths like "You can't take profit if you've not been profitable" or "You must spend to grow." Instead, ask yourself: "How can we deliver what we're delivering at 20-30% of the cost?" or "How can we get double the results at half the effort?"
- Examine all aspects of your business: figure out how to do the fewest possible things that matter most to your top clients in the best possible way. Consider both incremental improvements and big innovations. Remember: If you don't find cheaper and better solutions, your competitors will.
- 20% of your clients will yield 80% of your profits, while another 20% of your clients will give 80% of your problems. Weed out your worst clients (who pay the least, are late in their payments yet generate many issues) and duplicate your top clients (who love your business, pay top fees on time and share your services with others). If you focus all your energy and efforts on serving your top clients most efficiently, your profits will multiply.



- Sell smarter, not harder. Without efficiency, every sale you make will be lost via expenses. However, when you improve efficiencies and squeeze the most from every dollar, you retain more of every new sale to generate real profit.



## Getting Started



Fundamentally, Profit First is a way of life. It's about changing how you do business so you actually get what you wanted in the first place—financial freedom and the ability to do what you want to do. You can also apply the principles to manage your personal finances.



However, nothing will happen if you don't take action. If you're still dragging your feet, then minimally start with these baby steps:

- Set up your PROFIT account now. Don't worry about the bank or account type. Just start an account and name it "PROFIT".
- The next time you receive a deposit in your normal account (regardless of the amount), transfer 1% into your PROFIT account. Then continue to run your business using the remaining 99%. See for yourself that the process isn't scary, and you can start to take profits immediately.



Once you're familiar with the Profit First system, you can move on to advanced Profit First techniques, including adding accounts to address specific business needs like materials, reimbursements, payroll or petty cash. You're ready for these techniques if you've met 4 criteria: (i) you've implemented the system for  $\geq 2$  full quarters, (ii) have a firm biweekly routine for allocations, (iii) started to accumulate some profits and (iv) are accountable for your numbers.

## Other Details in the Book to Look out For



If you still don't believe Profit First can work for you, the book includes many examples of entrepreneurs who've turned their businesses around using this approach. Michalowicz also shares various scenarios and tips on how to apply the system and the



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## KEY QUOTES

*"Sales without first putting efficiency measures and systems in place is a dangerous game that only leads to bigger expenses and fewer ideal clients."*

*"When profit comes first, your business will automatically show you the path to growth."*



mistakes to avoid. To download the Instant Assessment form and get the latest updates about Profit First, please visit [MikeMichalowicz.com](http://MikeMichalowicz.com)

## About the Author



**Michael Michalowicz** (born 1970) is an American author, speaker, entrepreneur, and lecturer. He has contributed to or appeared in various publications and programs, including being a former columnist for The Wall Street Journal and the “Business Rescue” segment host for MSNBC’s Your Business. He has also lectured on entrepreneurship, sales and marketing at various universities and organizations.

## About ReadinGraphics



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