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# PROFIT FIRST



ENJOY THIS GIFT FROM:

MIKE

Author of *THE PUMPKIN PLAN* and *THE TOILET PAPER ENTREPRENEUR*

## Chapter 1

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# YOUR BUSINESS IS AN OUT-OF-CONTROL CASH- EATING MONSTER

**N**o matter how many years you've been at the grind, you are probably well aware of the statistic that roughly 50 percent of businesses fail within the first five years. What they don't tell you is that those failed entrepreneurs are, in fact, the lucky ones! The majority of the businesses that survive are racking up debt, and their leaders are perpetually stressed. Most entrepreneurs are living a financial nightmare, one that's populated by Freddy Krueger or Frankenstein's monster in its raw, unadulterated scariness. In fact, I am convinced that I am Dr. Frankenstein.

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, could 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 we realized our creation was actually a monster.

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. Didn't you start a business so you could be your own boss? Now it looks as though this monster is the boss of you.

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 tens of 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—are one bad month away from total collapse.

My own wake-up call came in the form of my daughter's piggy bank.

## THE PIGGY BANK THAT CHANGED MY LIFE

I lost 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 cofounded—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, and what I have subsequently found many people identify as the "that-guy-must-have-a-tiny-penis" car), something I'd promised I would get for myself "one day" when I'd "made it," 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 that I was about to learn the difference between making money (income) and taking money (profit). 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 in order to avoid the cost of hotels when visiting clients. 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.

That day was the beginning of the end. I was well on my way to discovering that while I knew how to make millions, what I was really, really proficient at 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 whether the founders of these companies knew what they were doing? No—I had all the answers (read that with a massive douche 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 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 *douche* emphasis).

Then, I started writing checks—\$5,000 to one person, \$10,000 to another, every month more checks, and still more. One time, I cut a check for \$50,000 to cover expenses for one of these companies. I was focused on one thing and one thing only: growth. Mindlessly throwing money at start-up companies wasn't even in alignment with my values about money; I was a bootstrapper and proud of it. Still, I was blind to my mistakes. I was all pump and dump. Grow the businesses, then sell them. 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'd invested in, except one, had gone 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 fourteenth of 2008, I was down to my last \$10,000.

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 (not to be confused with Keith, the hot-air balloon guy). He said, "Good news,

Mike. I got a jump start on your taxes this year and just finished your return for 2007. You owe only twenty-eight thousand dollars.”

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 the 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 OK. 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. 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’d learned what net worth really is, thanks to my nine-year-old daughter. That day I also learned that no amount of talent, ingenuity, 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 (if you did the “ice bucket challenge” a couple of years ago, you know the spine-shuddering chill I am talking about). 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.

## **MONEY PROBLEMS**

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. 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 there is something big you are intended to do 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 were 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:

Sales slow down. The problem here is obvious when you operate check-to-check and sales slow down: when your one big client goes out of business, or that big deal you were banking on falls through, you won't have enough to cover expenses.

Sales speed up. This problem here is not obvious, but it is insidious. As your income climbs, expenses quickly follow. Big deposits feel great, but they are irregular. Consistent incoming cash flow is hard to sustain. A great quarter can trick you into believing your business is on a permanent upswing, and you start spending like this is the new normal. But 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. We don't want to admit we've been wrong in how we've been growing our business. 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 eight 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.

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.

## **BIGGER IS NOT BETTER**

Why the hell is success constantly defined by applying the *Super Size Me* principle to your business? Does more revenue mean you are more successful? No. I know far too many big businesses with owners who are in pure panic and use lawn furniture to decorate the inside of their houses because they have to funnel every spare penny into their businesses to keep them from sinking. Is that success? Hardly.

Growth is the battle cry of nearly every entrepreneur and business leader. Grow! Grow! Grow! Bigger sales. Bigger customers. Bigger investors. But to what end? Bigger business means bigger problems for sure. Yet it surely does not guarantee bigger profits, especially when profit is a hopeful residual.

Growth is only half the equation. It is an important 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. A little mutant 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. A \$300,000 cash-eating monster is much easier to manage than a \$3,000,000 one. I know; I have survived operating both.) 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.

Jason Fried, cofounder of Basecamp, wrote an article for *Inc.*\* in which he talked about the demise of his favorite Chicago pizza joint. The owners did everything right—except that they grew too fast. After building their business slowly, they suddenly scaled from twenty to forty locations. Sales could not outpace their debt, and Fried's beloved pizza chain was forced to close. The perfect size for your business? It will happen naturally, when you take your profit first. You will reverse engineer all the elements of your business, and as Fried says, “the right size will find you.”

So why are entrepreneurs programmed to pursue bigger and bigger and bigger? Because of an assumption that at a certain point all that revenue will yield a profit. You think you just need one more big project or one more new client or just a little bit more time, and finally that profit will pour in. But it never does. Profit is always within sight, but never attainable. It's like the donkey with a carrot dangling over its head. The jackass keeps working harder and harder, but never gets to the carrot. It's always just one more step away. The problem is, that jackass . . . is you. (Sorry about the brutal honesty. I hurt you because I love you.)

Here's the deal, my friend: Profit is *not* an event. Profit is not something that happens at year-end or at the end of your five-year plan or someday. Profit isn't even something that waits until tomorrow. Profit must happen

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\* “Why Growing Fast Will Make Your Company More Mediocre,” May 2016.

now and always. Profit must be baked into your business. Every day, every transaction, every moment. Profit is not an event. Profit is a habit.

Do you know the saying “Revenue is vanity, profit is sanity, and cash is king”? It is a succinct reminder that your job is to maximize profit, regardless of the current size of your business. As you focus on profit, you’ll discover new ways to both streamline and grow your business. It doesn’t work the other way around. The lemming mentality of growing first with the hope of finding profit in the process, is so bass ackward it drives me nuts.

Recently I delivered a speech in tiny Georgetown, Colorado, at an event hosted by my dear friend Michelle Villalobos. As often happens in my Profit First presentations, one of the entrepreneurs said, “This sounds great and all, but I need to grow. I need to put all of my money back into my business to do that.”

Perhaps you’re thinking the same thing right now. If you are, it’s because you’re stuck in the mode of “grow now, profit someday.”

I asked her, “Why do you want to grow?”

“I want to grow so that my company can manage more clients and generate more sales,” she said.

“Why do you want that?”

She looked at me as if I were an alien. “So that my company is bigger, Mike.”

“Why do you want a bigger company?” I asked.

“So I can make more money,” she responded. I could tell from her tone that she was getting exasperated.

“Aha!” I said. Now we have peeled back that good ol’ Georgetown, Colorado, onion (which, let me be clear, is not known for its onions.) “Why not just make more money now?”

She wants to grow, grow, grow so that she can make a profit one day. Alternatively, if you want to grow for ego, and to boast, that is just dumb (cough—that’s exactly what I did in the past—cough—so embarrassing—cough). If you want to grow to make money for yourself one day, you are playing a game of kick the profit can down the road.

Here’s the reality if you want healthy, sustainable growth—which, not so surprisingly, will spawn more healthy growth—you need to reverse engineer the profit. Take profit first. You can’t grow out of your profit prob-

lem. You need to fix profit first, then grow. You must figure out the things that make profit and dump the things that don't. When you focus on growth, it is inevitably a scramble to grow at all costs. Yes, at all costs (including the quality of your life). When you focus on profit first, you inevitably figure out how to make a profit consistently. Profitability. Stability. Sanity. Forevermore.

## 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 \$4,000 past-due invoice you wrote off months ago and later that week your delivery truck breaks down—for good. Bye-bye, \$4,000. 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 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.

What do we do when instead of a decent bank balance, we see that there's next to nothing there? We immediately panic. 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. But I bet you check your bank account every day, don't you? It's OK. 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 is our natural desire as entrepreneurs 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 selling 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 confident are you that you could 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 human 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 mind-set 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 a trap—a dangerous trap that would even have Frankenstein’s monster poopin’ his panties. It’s the Survival Trap.

## THE SURVIVAL TRAP

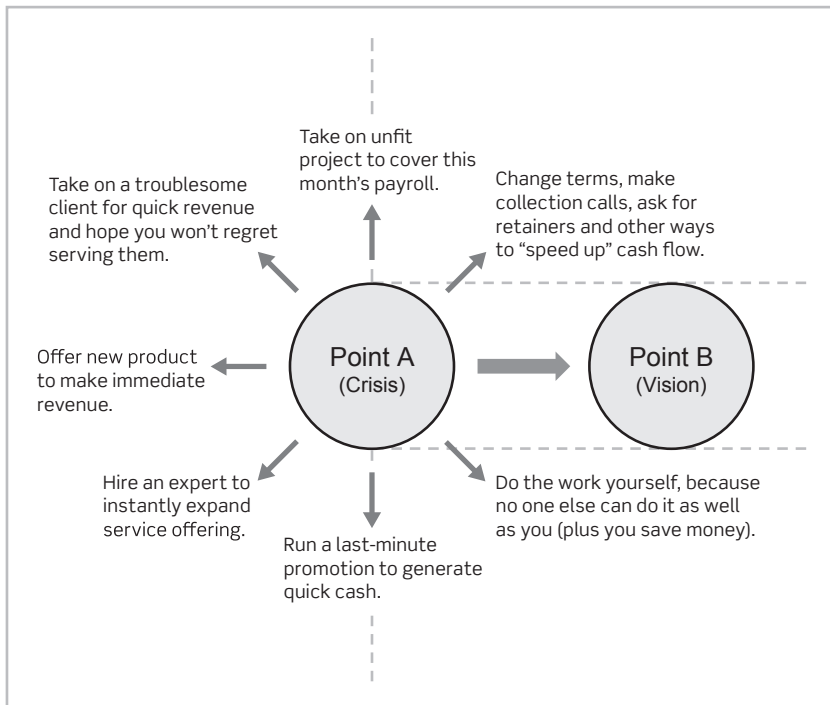


Fig. 1. Survival Trap.

My lawn guy, Ernie, is a good example of someone caught in the Survival Trap. As is true for most lawn guys in the Northeast, Ernie makes good money removing leaves from lawns. Despite this, Ernie is always in need of more revenue. This past fall he knocked on my door and said that he noticed leaves in my gutters and would gladly clean them up. He had a captive client (me), and could 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?

Sounds like a smart guy, right? Except that he’s an idiot. (Let me be

clear: Ernie is a great person. He truly is. Ernie has great goals and ambitions. It's his decision to expand his offering and expand his offering further that is pure idiocy.) Any sale feels like a good sale because sales help to temporarily lift us out of crisis.

Take a look at Figure 1. Ernie is at point A (which is really called crisis) and he wants to get to point B (which is his vision for our future). The thing is, as is the case for most of us, his vision is very vague. Instead of a clear statement of his products or services and the clients he wants to serve, Ernie might have a goal like, "I want a lot of money and need relief from stress." The connection between point A and point B is never defined beyond, "Sell, baby! Just sell anybody anything!" Looking at the figure, you can see that many of the decisions we make around "just selling" in fact take us further away from our true vision. When Ernie offers me a new service, because it will make fast money, he hasn't considered that it has nothing to do with what he wants his company to become or whom he wants his company to serve.

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 important, 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 further from his lawn-raking business.

The Survival Trap promises fast money, but when we're caught in it, we, like Ernie, 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 becoming less and less efficient at each step while our businesses become harder to manage and costlier 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 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. 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.

Other actions shown on the diagram don't take us in the opposite direction, but they are askew. Only when you stay in the channel of the horizontal dotted lines do you make your vision for your business a reality.

The Survival Trap is deceptive because it fools us into thinking we are at least inching toward our vision, as if our reactionary behavior is actually "smart" or evidence of our good instincts, and will eventually lead us to the promised land: financial freedom. Consider the actions on the right side of Figure 1. For instance, a "just sell" approach will, by pure happenstance, also occasionally move us toward our vision, and 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 is 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.

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

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 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 further supported by the traditional accounting method public companies must use and most small businesses elect to use: GAAP (Generally Accepted Accounting Principles).

## TRADITIONAL ACCOUNTING 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:

$$\text{Sales} - \text{Expenses} = \text{Profit}$$

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, employee salaries, 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.

The traditional accounting methods we use today 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). Whether you outsource your bookkeeping or keep a shoebox of receipts under your bed, the basic idea stays the same.

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 *Bridezillas* 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, desperate growth process, our expenses are lost in the wash—we just pay as we go. They're all necessary, right? Who knows? We're too busy hunting down sales and trying to deliver on all 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 expense. We can't. The more variety of stuff we sell, the more our cost of doing businesses rises. They say it takes money to make money. But no one ever tells us what that translates to in the real world: It takes more money to make less money.

As our monster gets bigger, its appetite 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 ones: 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 that 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 our spending choices. Everything is justified. Soon enough, whatever money we had in the bank dwindles down to nothing as we struggle to cover every "necessary" expense. And that's when we find ourselves in the Survival Trap.

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. It's something called the Primacy Effect (more on that in the next chapter)—we focus on what comes first (sales and

expenses) and actually become blind to what comes last. Yes, GAAP makes us blind to profit.

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 its overwhelming complexity. 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!

Before we go any further, I want to make sure you and I are on the same page when I talk about profit. Because the way accountants think about profit can be very different.

Here’s what I mean: A couple of years before I wrote *The Toilet Paper Entrepreneur*, I was sitting in my accountant’s office, watching him scratch down some notes with a pencil on a legal pad. He erased something, then wrote down another note. Then he looked at his computer, clicked and clacked a few buttons, and the dot matrix printer spit out a report.

“Yep. Just as I thought, Mike,” Keith said, peering over his John Lennon wannabe glasses.

“What?” I said.

“You had a \$15,000 profit this year. Congratulations, that isn’t too bad.”

For a second I felt pride. Damn straight there is a profit. I patted myself on the back. Then I had a sinking feeling. Where was the cash? There wasn’t a penny in the corporate coffers, let alone in my pocket.

Then, feeling embarrassed that I didn’t know the answer, I asked, “Hey, Keith, where is the profit?”

He pointed to the paper report that the printer had just spit out. He circled it on the paper with his fancy-schmancy number 2 pencil.

“Yes, Keith, I can see that profit on the paper. But where is the cash? I want to take it out and celebrate a little. I want that profit for me.”

There was a moment of awkward silence. Keith did his best to avoid making me feel stupid. He stared at me. Then he said, “This is an accounting profit. You spent the money in some way already. It doesn’t mean there is any money actually there right now. In fact, in your case it’s already gone. This is just the accounting of what already happened.”

“So are you saying I have a profit, but there is nothing in the bank for me to take as a profit right now?”

“Exactly,” said the John Lennon poseur.

“Damn! This sucks.”

“Maybe next year,” Keith said.

Next year? Why next year? Why not starting tomorrow? I thought.

Accountants define profit differently than entrepreneurs. They point to a fictitious number at the bottom of an accounting report. Our definition of profit is simple: cash in the bank. Cold. Hard. Cash. For us.

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 are sustained.

GAAP was never intended to manage only 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 (or work with an accountant and bookkeeper who do), because they will give you a holistic view of your company; they are powerful and highly useful tools. But the essence of GAAP ( $\text{Sales} - \text{Expenses} = \text{Profit}$ ) 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 within seconds, without help from an accountant. We need a system 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 and stay 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.

## PROFIT FIRST IS BUILT FOR HUMANS

How many times did Spock stare into Captain Kirk's eyes and say, "That is highly illogical"? Well, just like you, Captain Kirk was a human, and humans are not logical. We are emotional beasts with monkey brains. We like shiny objects; we stuff ourselves when there's free pizza; we buy twelve pounds of cat food just because it's on sale, even though we don't have a cat. (OK, maybe that's just me.) But we also know to trust our gut, go with our instincts, take shortcuts, and be inventive on the fly so we can move on and get more things done.

If you were Spock, the relentlessly logical Vulcan on *Star Trek*, in addition to your pointy ears and awkwardly tight uniform, you would follow all the accounting instructions necessary to pinpoint your numbers. On a weekly basis you would study your income statement, tie it into your balance sheet, and, of course, do an analysis of your cash flow. Next you would run the critical ratios, like the OCR (operating cash ratio), and tie all this into your budget and projections. Then you would evaluate the associated KPIs (key performance indicators). You would do it all, and you would know exactly where your profits stand at any time. But you don't, do you? Not even close. I don't. In fact, I still can't read those documents well. (That's why I employ a couple of Spocks—my accountant and my bookkeeper.) I am a human. And so are you. And I strongly suspect you are a Captain Kirk. And that is a good thing, because you are the perfect person to lead your corporate ship to profits at warp speed.

As a human, you likely have certain tendencies. Chances are you log into your bank account every few days, or maybe a few times a day, to see what your bank balance is. You probably make gut decisions based upon the balances you see. A lot of deposits and you feel good. Business is cooking! Let's take our clients out for bottomless margaritas! Let's buy that foosball table for the office! No money and panic sets in. Need to start making collection calls! Sell the foosball table! Sell the rad vending machines! Sell all the chairs! Sitting is bad for you anyway! All while praying that someone buys *you* a bottomless margarita. This and other normal human behaviors put businesses, unintentionally, into a constant state of flux.

But I have good news, people. I designed Profit First so that you don't have

to change yourself at all. This is a critical point. You have always had an opportunity to change yourself and read your financial statements, sync your accounts payable and accounts receivable, make sure you are within budget, and make sure all the financial ratios are right. If you did all that, you would know where your profit stands all the time. But only Spock and accountants (and actually not that many of them) can and do that. Most entrepreneurs revert to checking their bank balance and going with their gut. Why?

As Charles Duhigg explains in *The Power of Habit*, it is human nature to revert to established habits in times of stress. And guess what? The definition of entrepreneurship is constant stress. So we look for shortcuts and quick answers, especially with our finances. The great news is that Profit First is within your natural path. It is directly in alignment with the shortcut of looking at your bank account. It is unavoidable, designed to complement your natural human behaviors; therefore, it works.

Established habits die hard, so why try changing your habits? Instead, use a system that works with your existing habits.

Profit First sits in front of your accounting. It will tell you when you have a red flag and need to dig into the complex accounting stuff (with your qualified\* accountant or bookkeeper), and it will show you exactly where your cash stands at any given moment. You'll know your profitability, your reserves for taxes, what you are getting paid, and the amount you have to run your business operations. All that and more.

## HAPPILY EVER AFTER

The ending of *Frankenstein* (spoiler alert) is one of the most heartwarming happy endings in literature. Dr. Frankenstein and the monster talk it out

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\* To find a qualified accountant, bookkeeper, or coach to support your business, I encourage you to visit [ProfitFirstProfessionals.com](http://ProfitFirstProfessionals.com) and choose the FIND option. I have vetted the best of the best providers throughout the globe, trained them in the nuances of Profit First, and continually work with them—as they work with their clients—to grow their profit skills. My team will gladly introduce you to a Profit First expert who we believe will be a perfect match for you. And if you act within the next fifteen minutes, you will get a free set of Ginsu Knives. (That's a joke, people. The part about the Ginsu knives, I mean. The Profit First Professionals are very real, I assure you.)

and reconcile their differences, become best friends, and go into business together to create a hugely successful and beloved ice-cream brand, Frank & Stein's. Leaves me in joyful tears every time.

Just kidding. If you've read the book, you know that 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.

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 simple. In fact, you will fundamentally understand it, and implement it, within just a few more chapters.

## **TAKE ACTION: SEND ME AN EMAIL**

It's time to draw the line in the sand and get some accountability. Email me right now (my email is [Mike@MikeMichalowicz.com](mailto:Mike@MikeMichalowicz.com)) with the subject line "I've Drawn the Line in the Sand," and tell me that you are committed to profitability. And tell me that you will do what it takes to once and for all become permanently profitable. If you are all in on this, I want to know it. Email me. Commit. Let's do this.



## Chapter 2

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# THE CORE PRINCIPLES OF PROFIT FIRST

**Y**ou would think that my daughter presenting me with her piggy bank as a way out of our financial ruin would have compelled me to change.

You'd be wrong.

That Valentine's Day was a defining moment, for sure. The problem was, I had no idea where or how to begin. In reality, wake-up calls are rarely as depicted in the movies. I didn't hear "Eye of the Tiger" playing as the soundtrack of my life, spurring me into an inspired training montage; there was no drinking raw eggs, punching my debt into submission, or running up the steps to raise my fists in the glory of an entrepreneurial turnaround. Instead, I entered a very dark period of depression and insomnia. The shame I felt was overwhelming—ashamed of my idiocy, of my lies of omission, of my lack of courage to tell my wife the truth about how bad I'd made things.

I share this with you not to seek your pity, but because I think you may have your own version of the story, and I want you to know you're not alone. And if you haven't gone to the dark place, know that it can be avoided. I emphatically believe that. Profit First is the solution to pending disaster in business.

Here is how I dealt with depression: I hit the bottle (beer bottles actually . . . and lots of them). I'm really not much of a drinker at all. But I started to rely on it as my escape. That choice just led to more shame, and I hid it as best as I could—if slumping on the couch, watching infomercials, surrounded by Bud Light cans is hiding it. Imagine me in a white undershirt

covered with Cheetos stains. It's not a pretty picture. And I don't even *like* Cheetos.

Why was I watching infomercials, when we now have 2,976 channels to choose from? Because when I blew it all, cable TV was the first thing to go. That left me with a rabbit ear antenna (Google it, young padawans) and five network channels that, at three a.m., regress to pitching the latest vegetable pulverizing box or electrocuting belt—all promising ripped abs.

Tired of infomercials, I turned on PBS. A fitness expert was explaining to the studio audience that the quick fixes lauded by late-night diet infomercials didn't work and weren't sustainable. He said that what we really need are simple *lifestyle* fixes that change how we eat without our even really noticing. And his first fix suggestion? Smaller plates.

Now riveted, I watched as the man explained that our natural human behavior is to fill up our plates with food, and because Mom said so, clean that plate by eating everything on it. (I still don't get Mom's logic—there are children starving in Africa, so I need to stuff myself?) The clean-your-plate behavior 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. 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 when we use smaller plates, we dish out smaller portions, thus eating fewer calories without changing our ingrained behavior of serving a full plate and eating all of what is served.

I sat up straight 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 huge 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. While my businesses were doing well, it was easy to think I knew how to manage money well, but looking back, I realize that that was never the case.

I thought I was frugal in principle, or because I was a savvy entrepreneur. But in truth, I was frugal only when 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 found ways to do all that with practically no money because I didn't have any.

As the business grew, I started to spend. The more money came in, the more I spent, and I believed—scratch that, I was convinced—that all expenditures were necessary. We needed better equipment, a better office (an unfinished basement is no place for a business), and more employees to do the work so I could focus on sales. Every step forward in sales growth required an equal step up in my infrastructure, human resources, grade A office space—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 it's easier to make things happen with a hundred thousand dollars in hand, it's also 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.

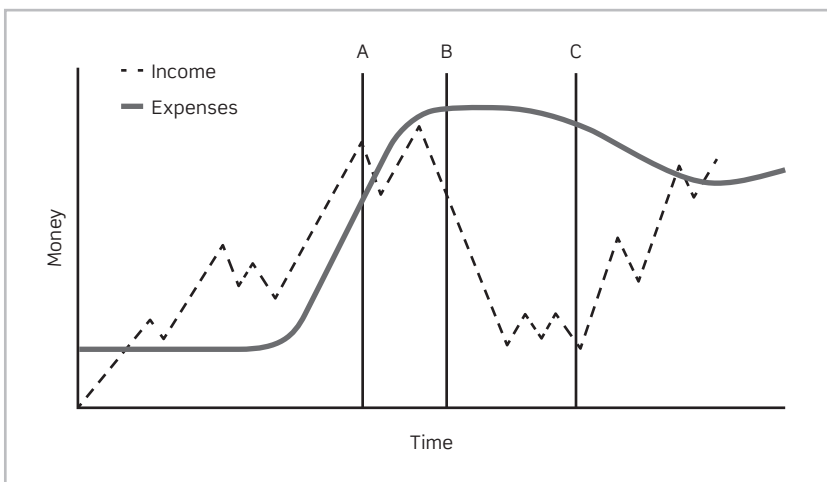


Fig. 2. Income Versus Cost.

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 dotted line in the chart), my expenses increased at a similar rate (solid 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 (point A). However, I would quickly ramp up my expenses to serve my "new level of sales" (point B). Then sales would settle back down, or drop, while my new level of expenses remained higher (point C), which meant I started to accumulate losses, making me desperate to sell more and sell faster at any cost (which could, in turn, further increase my expenses).

As the PBS show shifted into early morning kids' programming, I muted the television and began to connect the dots (which Count von Count, the vampire on *Sesame Street*, was also doing, literally connecting dots on the screen). If I reduced the "plate size" of my business's operating account, I would spend differently. So rather than try to curb my spending habit, I would create the experience of having less cash on hand than I actually had, and then would find ways to still make things work. How did I know this would work? Because it already works for millions of people with every paycheck—think 401(k) deductions. As Richard Thaler and Cass Sunstein explain in their fascinating book *Nudge*, when people start participating in 401(k)s, they rarely stop. The key is to get started so both the savings accumulate and the lifestyle adjusts to meet their residual pay.

If 401(k)s were like regular savings accounts, people would find it way too tempting and easy to dip into their savings anytime they felt like it. The reason they don't is because investment accounts charge penalties and make it difficult to withdraw money whenever you want. In the same way, I could make myself believe and behave as if I had only my "small plate" money to work with (and not a small plate plus a big Crock Pot at the table).

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 idea was a revelation. At six a.m., with beer breath, Cheetos stains covering my undershirt, and hair going in more directions than Einstein's,

it sounded like crazy talk. Who would have the audacity to take profit first? I would.

## THE FOUR CORE PRINCIPLES OF PROFIT FIRST

Let's take a moment to talk dietary science. No groans, please. This stuff is fascinating.

In 2012, a report by Koert Van Ittersum and Brian Wansink in the *Journal of Consumer Research* concluded that the average plate size in America had grown 23 percent 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, and it is based on four core principles of weight loss and nutrition.

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**—If you eat the vegetables, rich in nutrients and vitamins, first, they will start satisfying your hunger. When you move on to the next course—your mac and cheese or mashed potatoes (they don't count as veggies!)—you will automatically eat less. By changing the sequence of your meals by eating your vegetables first, you automatically bring a nutritional balance to your diet.
3. **Remove Temptation**—Remove any temptation from where you eat. People are driven by convenience. If you're anything like me, when there's a bag of Doritos sitting in the kitchen, it calls out to you constantly—even when you aren't hungry. 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.

**4. Enforce a Rhythm**—If you wait until you are hungry to eat, it is already too late and you will binge. Then you are likely to eat too much and stuff yourself. You go from starving to stuffed, and back to starving again. These peaks and valleys in your hunger result in way too much calorie consumption. Instead, eat regularly (many researchers suggest five small meals a day) so that you never get hungry. Without the peaks and valleys, you will actually eat fewer calories.

Though they don't realize it, the folks in the diet industry know quite a lot about growing a healthy business. Let's examine these principles one by one:

### 1. Parkinson's Law: Why Your Business Is Like a Tube of Toothpaste

In the years since I discovered these four physical health principles, I dug further and further into why they matter. The four principles that the PBS fitness expert shared are all rooted in behavioral science. When you know what makes you tick, it gives you a massive advantage over yourself. Behavioral science gives you the advantage to subdue your biggest competitor, namely, you.

Let's start with small plates. In 1955, a modern philosopher named C. Northcote Parkinson came up with the counterintuitive Parkinson's Law: that the demand for something expands to match its supply. In economics, this is called induced demand—it's why expanding roads to reduce traffic congestion never works in the long term because more drivers always show up in their cars to fill those extra lanes.

In other words, if you went to a Spanish tapas bar that served those tiny plates, you would eat less. But if you went to a Ponderosa all-you-can-eat buffet, where they have plates the size of manhole covers, you would eat until the food was coming out your ears. (It's an all-you-CAN-eat buffet . . . Challenge accepted!)

Similarly, if your client gives you a week to turn around a project, you'd likely take the whole week—but if she gives you just a day, you'll make it happen in a day. You see the more we have of something, the more of it we consume. This is true for anything: food, time, even toothpaste.

How much toothpaste do you use when you have a brand-new tube of

toothpaste? A big ol' glob of it, right? I mean, why not? After all, you have a full tube of toothpaste. So you put a nice long bead on that brush of yours. Then before you start brushing, you turn on the faucet to moisten up the brush a little. Then it happens . . . damn it, the paste falls into the sink. But who cares, right? You just opened up that tube, for God's sake! You have tons of this stuff. So you put on another big ol' glob and brush away.

But when you open that cabinet drawer and find a nearly empty tube . . . my oh my, how the game changes. It starts off with an insane amount of squeezing, twisting, and turning. You reach for your toothbrush, momentarily releasing a little bit of your viselike grip on the tube, and with that, like a tortoise's head when a three-year-old comes at it with a stick, the paste shoots back into the tube. You could shout out some expletives at this point, but you can't because you are already onto stage 2 of toothpaste extraction: biting down hard on the tube. With a precarious balance of biting, one hand squeezing and tube twisting, while your other hand somehow tries to get the brush bristles to scoop out toothpaste, you have a victory. One droplet of toothpaste. Which is just enough for that fresh-mouth sensation.

Isn't it funny how much *we* change based upon what is available? Here is what's fascinating: Parkinson's Law triggers two behaviors when supply is scant. When you have less, you do two things. The first is obvious: you become frugal. When there is less toothpaste in the tube, you use less to brush your teeth. That is the obvious part. But something else, far more impactful happens: you become extremely innovative and find all sorts of ways to extract that last drop of toothpaste from the tube.

If there is one thing that will forever change your relationship with money, it is the understanding of Parkinson's Law. You need to intentionally make less toothpaste (money) available to brush your teeth (to operate your business). When there is less, you will automatically run your business more frugally (that's good) and you will run your business far more innovatively (that's great!).

If you first extract your profit and remove it from sight, you'll be left with a nearly empty toothpaste tube to run your business. When less money is available to run your business, you will find ways to get the same or better results with less. By taking your profit first, you will be forced to think smarter and innovate more.

## 2. The Primacy Effect: Why the *First* Part of Profit First Matters

The second behavioral principle you need to understand about yourself is called the Primacy Effect. The principle is this: We place additional significance on whatever we encounter first. Here's a little demonstration that may help you understand.

I am going to show you two sets of words. One set describes a sinner and another describes a saint. The goal is, as quickly as possible, to determine which one is which. Got it? Good. Now look at the two sets of words below and determine which one describes the sinner and which one the saint.

1. EVIL, HATE, ANGER, JOY, CARE, LOVE
2. LOVE, CARE, JOY, ANGER, HATE, EVIL

At first glance you likely identified the first set of words to be the sinner and the second set of words to be the saint. If you did, that is wonderful news, because it means you are a human being and are experiencing the Primacy Effect. In other words, you will thrive under Profit First. If you tried to figure out the catch as you were going through the exercise, that is awesome news, too; it means you are an entrepreneur and are more than willing to break old systems (like reading left to right only), which also means you will thrive under Profit First.

Now look at the set of words again. You will see that both sets of words are identical, just in the opposite sequence.

So when you see EVIL and HATE at the start of a set of words, your mind assigns greater weight to those words and less weight to the remaining words. When the set started with LOVE and CARE you put the weight there.

When we follow the conventional formula of  $\text{Sales} - \text{Expenses} = \text{Profit}$ , we are primed to focus on those first two words, *Sales* and *Expenses*, and treat *Profit* as an afterthought. We then behave accordingly. We sell as hard as we can, then use the money we collect to pay expenses. We stay stuck in the cycle of selling to pay bills, over and over again, wondering why we never see any profit. Who's the sinner now?

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



### 3. Remove Temptation: Once You Take Your Profit First, Put It Away

My greatest weakness is Chocodiles: Twinkies covered in dark chocolate, filled with cream, 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 nowhere around.

Money works the same way. As you implement Profit First, you are going to use the powerful force of “out of sight, out of mind.” As you generate a profit (which, remember, starts today), you are going to remove the money from your immediate access. You won’t see it, so you won’t access it. And just like anything that you don’t have a reasonable degree of access to, you will find a way to work with what you do have and not worry about what you don’t. Then, when Mr. Buffett (ahem, your profit account) releases money to you, it will serve as a bonus.

### 4. Enforce a Rhythm

Just as it keeps us from starving and bingeing on food, enforcing a rhythm works with money, too. When we get into a rhythm (I will explain in Chapter 6 a twice-a-month method that I call the 10/25 rule), we don’t get into the reactive mode of crazy spending when we get big deposits and panicking in the face of big cash dips. I am not saying the money will automatically appear and you’ll always have cash at your disposal, but establishing a rhythm will get you out of the daily panic.

In fact, establishing a rhythm will also be a great indicator of overall cash flow. This system is the easiest way to measure cash flow. Instead of reading the cash flow statement (which, honestly, when was the last time you did that?), you can measure your cash flow by just checking your bank accounts, which you do anyway.

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\* For my Chocodile-loving comrades: Supposedly Hostess has reintroduced the product, albeit slightly reformulated. Distribution is sparse, yet I have got my hands on a few. If these are the new formula, they taste like they have been on the shelf since 1972 . . . and they are still delicious.

When you get into a rhythm with your cash management you'll have your finger on the pulse of your business. You will monitor your cash position every day by just looking at your bank account. Log in. Spend two seconds looking at your balances. Log out. You will know where you stand that quickly. Think of your cash flow as waves rolling onto the beach. If the cash wave is big, you will notice and take action (this is when looking at the reports with the guidance of a pro is helpful). When the waves are small, you will surely notice that, too. Most of the time, I expect the cash waves will be normal, and no action will be required. But no matter what, you will always know. Because you will continue to do what you normally do: log into your bank account.

### **BUT IF I SET ASIDE MY PROFITS, HOW WILL I GROW?**

This is a question I get asked a lot. By now I hope I've convinced you that chasing growth for its own sake is how you wind up broke and out of business. But that doesn't mean growth doesn't matter, or that you shouldn't want it.

Growth strategies have been part of my spiel for years. I have now written multiple books on the idea of fast, organic growth (like my book *Surge*). But like most entrepreneurs, I always used to think it was one or the other. Either you could grow or you could be profitable—you surely couldn't do both. I was wrong.

What I've found is that the fastest, healthiest growth comes from businesses that prioritize profit. And it is *not* because they plow money back into their businesses. Businesses that plow back their profits aren't truly profitable; they are just holding money temporarily (feigning profit), then spending it, just like any other expense.

Profit First sparks faster growth because it makes you reverse engineer your profitability. When you take your profit first, your business will tell you immediately whether it can afford the expenses you are incurring; it will tell you whether you are streamlined enough; it will tell you whether you have the right margins. If you find that you can't pay your bills after taking your profit first, you must address all those points and make the fixes.

Taking profit first will help you figure out which of the many things you do makes money, and which don't. Then the direction is obvious—you do more of what is profitable, and you fix (or dump) what is not. You will focus on what makes profit for you, naturally, and you will get better and better at it. And when you get better at what your customers already want and like, they will like you more. All this translates into fast, healthy growth. Boom!

Specialists, such as heart surgeons, know the secret. Keep doing a few things (like heart surgery) really, really well, and you will attract the best customers, dictate the biggest premiums, and see your practice grow to be world renowned. Alternatively, the general practitioner does everything (from hangnails to rashes, coughs, and colds), but never specializes and therefore attracts the general customers. And when things get serious for the patient—that cough is actually indicating heart disease—the general practitioner refers the work to the specialist (who then collects all the premium money for her services). Specialists own the biggest houses in town, while general practitioners can't pay off their student loans.

To grow the biggest and the fastest, you need to be the best at one thing you do. And to become the best at something, you need to first determine what you are best at and do it a whole lot better. To get there, you take your profit first and the answers to being the best at something will reveal themselves.

## THE NEW ACCOUNTING FORMULA

Now you know the psychology behind how you work. The next step is to put a system around the normal you. And we start with a simple new Profit First formula:

$$\text{Sales} - \text{Profit} = \text{Expenses}$$

What you are about to learn isn't anything new (not even to you). 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 envelope-money management system” meets your preexisting natural, human tendencies.

Here’s how you apply the four principles:

1. **Use Small Plates**—When money comes into your main INCOME account, it simply acts as a serving tray for the other accounts. You then periodically disperse all the money from the INCOME account into different accounts in predetermined percentages. Each of these accounts has a different objective: one is for profit, one for owner compensation, another for taxes, and another for operating expenses. Collectively, these are the five foundational accounts (Income, Profit, Owner’s Comp, Tax, and Operating Expenses), and where you should get started, but advanced users will use additional accounts, outlined in Chapter 10.
2. **Serve Sequentially**—Always, *always* allocate money based upon the percentages to the accounts first. Never, ever, ever pay bills first. The money moves from the INCOME account to your PROFIT account, OWNER’S COMP, TAX, and OPEX (OPERATING EXPENSES). Then you pay bills only with what is available in the OPEX account. No exceptions. 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 that your business is telling you that you can’t afford those expenses and need to get rid of them. Eliminating unnecessary expenses will bring more health to your business than you can ever imagine.
3. **Remove Temptation**—Move your PROFIT account and other “tempting” 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 allocations and payables twice a month (specifically, on the tenth and twenty-fifth). Don’t pay only when there is money piled up in the account. Get into a rhythm of allocating your income, and paying bills twice a month so that 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.

By the time 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. I had given up booze and infomercials as coping mechanisms, and my depression had lifted. 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. 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.

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 with great success. People like Jesse Cole, owner of two AAA baseball teams, who, while growing his businesses, paid off nearly \$1 million in loans. 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 stories about people who are in lock-step with their profits, and stories about other folks, like you and me, who were giving it their all but still ended up breaking even only on their best days—people who now turn a profit every month and enjoy the fruits of their labors. People like José and Jorge, two entrepreneurs who started using Profit First in the first few months of launching their business and have experienced not only very respectable growth, but have continually taken in a 7 to 20 percent profit month after month.

## LOWER THE BAR

In their book *Switch*, Chip and Dan Heath explain the concept of “lowering the bar.” We entrepreneurs are all programmed to “raise the bar.” Go bigger. Live bolder. Take on more. But I have found that isn’t always the best way to gain momentum. And if you intend to be profitable, it is time we start with a small “low bar” step. I want you to take one small, simple, and easy action that will start you down the path of permanent profitability. There is no excuse because it is so easy.

Right now I want you to set up your PROFIT account. It is the first step in the Profit First system, so do it right now. Call your bank (or do it online) and set up one new checking account. Don’t get mired in whether it should be a savings account or a sweep account or any of that. The five seconds you spend thinking about it cost more than the little dribble of interest it will yield. Your goal is just to get started and not to slip back.

After setting up this new checking account at your bank, nickname the account PROFIT, and from this moment forward from any deposit you put into your normal checking account, transfer 1 percent of that deposit into your PROFIT account. Then proceed with your business and processes and money management as you have in the past. Just add to the PROFIT account, and never touch it (until you get to the section of this book where I explain what to do with it).

If you get a \$1,000 deposit, I am telling you, starting today, transfer \$10 into your PROFIT account. If you could run your business off \$1,000, you can surely run it off \$990. If you get \$20,000 in deposits, you transfer \$200 into your PROFIT account. If you can run your business off \$20,000 you absolutely can run it off \$19,800. You’ll never miss that 1 percent. It is a low bar.

But something magical will happen. You will start proving the system to yourself. You won’t get rich overnight this way, but you will get a wealth of confidence. You will have a flavor of how powerful it is to reserve your profit in advance. Your job is to stick with this small step for a while. Watch your profit accumulate. Yes, it is notably small, but it is profit nonetheless. The goal here is to win over your *mind*. The goal is for you to realize that this unfamiliar process of taking your profit first isn’t so scary after all. Then once you are digging the Profit First vibe, you are set for greater

success. Because you will be staged perfectly to do the rest of the system, and your heart will be in it. Big-time.

### **TAKE ACTION: EASY FIRST STEPS**

1. Trust the process. This works, but it is unfamiliar. So you will resist. Commit to, for now, relinquishing your resistance and comfort in doing what you did in the past. First, trust the process. Then prove it to yourself.
2. Open just one new account: PROFIT. For simplicity's sake, make it a checking account. Don't worry about the insignificant interest implications of savings and other accounts. Your goal for now is to get started immediately and decisively.
3. Transfer 1 percent of your current money into the PROFIT account. You have "seeded" the account. Don't touch it. Never transfer it. Just let it sit for now.