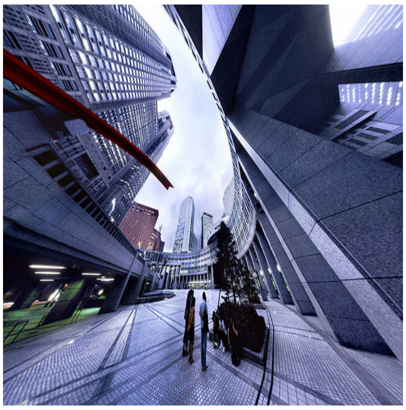

Start Distorting your Bottom Line

Description

Inflating your costs can startlingly improve profit!

Start Distorting Your Own Bottom Line
if you want to Really Succeed in Business

For the biggest returns you need to be absolutely honest about what you contribute to your business

This week I received the following Question:

> If a small business owner were writing out a financial plan for their business, couldn't it distort their bottom line profit if the owner is adding their own labor as a direct cost plus adding a salary for themselves? – the owner's labor is not a real "out of pocket expense".

As it comes up quite regularly and I have a very strong opinion about the answer, I thought I should address it publicly…

When Planning ALWAYS START by including ALL your time, money and non-financial contributions into the bottom line

The key point here is that by creating absolutely transparency around the actual gamble of owning your business you can make better decisions because you understand the true opportunity costs.
After making your Plan's first draft, and including everything, the principles and practice of what you do vary according to the decisions you need to make; which may also include shuffling things about for good tax planning. But far too often, these very real costs remain unconsidered (perhaps because they do not relate to cash outflows) and it is the lack of thought and planning I am wanting to highlight.
Firstly, take a step backwards and start by considering the two sorts of bottom lines that exist because there are two sorts of profits:

– **Income:** from Sales less Expenses (the “bottom line” we are talking about for annual business planning)
– **Capital Gains:** from selling the business (the ultimate “bottom line” we get when we step away)

It may be appropriate to trade off one for the other, so long as the whole profit overall improves. This trading-off short term gains for longer term capital gains may be a very good reason to “underpay yourself” when considering your annual budget. Critically, this trade-off needs to be measured and monitored to ensure it remains worthwhile year-in and year-out.

Here is very common example I see all the time….

If Frank leaves a job to go into business he is having a gamble he will earn more than he can in a job (leaving non-monetary factors such as happiness aside for now) â?? i.e. he is taking a risk that his profits (both sorts) over a period of years will be greater than his salary would have been for that same period.
Frank contributes time and money into setting-up the business â?? this may be his capital investment. As he does so he continues to increase his wager, with the view being the short term investment will pay-off as longer term capital gain GREATER than it otherwise would have made; and more than just leaving his savings in the bank (or at higher return than any money he might have also borrowed).
So in principle, to win this bet Frank (and every other entrepreneur ever) now needs to cover three components:

1. More income than the old job,
2. a pay back the investments of time and money to get set-up
3. and a return on the risk (this should at least be higher than keeping any savings in the bank).

In the “initial stages” of his new business Frank works long hours and wears many hats. His view is that one day he will sell this business for lots of money. He sets his prices based on what is competitors are doing, his profit is small… Frank spends most of his takings on marketing and advertising and some is reinvested in equipment, he draws a very small salary to just cover his personal expenses, but works without a budget or plan day-to-day, hand to mouth.
And, unfortunately this is where many business owners get stuck. The â??initial stagesâ?• drag on and onâ?¦ As the rate of growth of his business reaches a plateau (or worse starts to slip) so Frank continues to under-pay himself for his contributions AND starts to MINIMISE Income to reduce tax. At this stage he would be financially much better off either by making radical changes, or by going back to work; but he sticks it out because he doesnâ??t know how to fix it, and also doesnâ??t want to lose face.

That is terrible business management as far as I am concerned!

Now, letâ??s look at this another wayâ?¦.
If Frank started out with a very clear picture of the exact gamble he has taken, set a timeline of how long he is prepared to take the bet, AND he did an annual budget including all of his costs including all the time he plans on contributing, then he would begin with a point of **full understanding about how big a bet is he is making.** This would undoubtedly drive him to be very clear about his pricing, and what his weekly sales need to be, to make sure his gamble pays off.
At this point he should take a good look at what exactly is sufficient income to return more than his job, pay back his investments, and give him a return on his risk. This initial clarity is very terrifying and many people simply refuse to do it, but once he has gotten over the shock he can start making some good decisions.
Those decisions may be something along the lines of:

- He would initially set his prices to cover costs, plus a 15% mark-up, without including any of his time
- He is willing to forgo most of his normal wages for the next year as sales grow to $xxx.

- For the following TWO years he is willing to only take home a very small amount so he can invest in advertising and equipment until Sales grow by another 50%

Up to this point he is still gambling by trading off his short term take home salary, against his perception he will get a greater income(profit) and capital gains (profit) in the long-run. Then, some time in the first few years, the rate of business growth will most likely plateau.

- At the point of plateau the business will be known, so prices can be raised a bit to improve profit levels sufficiently for him to pay himself a full salary, comparable to if he was hiring someone to do the work for him, AND also pay some return for his risk.

After this the business is able to operate just like any company on the stock exchange, with a good separation of ownership receiving returns for investment (profits), and employees receiving returns for work (wages)
Now in practice, Frank may not CHOOSE to pay himself a salary covering any portion of his direct and/or management time, he may also choose to take that amount as a fancy car instead, or set up a trust to redistribute earnings to his family, or reinvest it to grow some more, etc etc. There are countless decisions that Frank can make to swap and shuffle things about to suit his world.
Regardless of how he shuffles things, Frankâ??s business is no longer dependent on him donating FREE time and effort for day-to-day business operation so he is able to step away and take a holiday, or (worse case) have an accident without any risk to the business continuity, because the business can afford to pay anyone else to do the same work.Â

The fact remains Frank took a gamble by going into business! Without fully understanding ALL his costs, if he excludes his time and contributions to â??boost his bottom lineâ?•, how will he ever know if he is winning his bet?

> **P.S. Iâ??m not specifically picking on people called Frank here, no Franks were harmed in this article…**
> It is just likely Ravi, Mary, Jacinta, Max and Ting Ting have all been guilty of this thinking! The phenomenon of avoiding proper financial management is a worldwide issue currently being researched by the OECD:
>
> > The awareness of the importance of financial education is gaining momentum among policy makers in economies the world over. The OECD and its International Network on Financial Education (INFE) provide a unique policy forum for governments to exchange views and experiences on this issue. http://www.oecd.org/finance/financial-education/
>
> Â

Â

Date Created
22 September 2014
Author
evediamond