Taking Wages versus Profit?

Description

Taking Wages versus Profit (or Both)

As a Business owner which is better Profit or Wages?

I am often asked this question:
Should I pay myself more, or take extra profit from the business?

The best way to work out the answer is to start with some definitions:

Profit is the reward for taking the **risk of investing** in a business
Wages* are the reward for the your **time and expertise** you contribute to your business

**NOTE ABOUT WAGES – for this article I am using "wages" to mean pretty well everything you pay for from the business, prior to paying company tax, that gives you a benefit; any salary, superannuation contributions, drawings, personal expenses, perks and Fringe Benefits Taxable expenses etc, that you take out of the for yourself or your relations.*

Taking Profit or Wages

So, how do your Wages and your Profit fit together?

As business owners we undertake 4 kinds of activities for our businesses, and we deserve to be paid well for every one of these:

1. **Worker** â?? doing stuff; serving customers and clients etc
2. **Manager** â?? coordinating stuff; making sure things run to plan and the timing and quality of goods and services are up to scratch
3. **Director** â?? deciding stuff; creating the plan, look and feel of the business including business strategy, and future directions
4. **Owner** â?? investing stuff; providing the backing, guarantees, and money to start (and often grow) the business

Often our accounts, and year-end reports are set up in such a way that it is very difficult to clearly identify what is being paid as a return on the investment and what payments relate to time. Messing the two up doesn't really matter until you want to actually assess if you are getting enough, or if what you are taking is reasonable, i.e. if you don't really care if your

business returns less than you could get elsewhere.
On the flip-side, identifying and tracking what you contribute, and if you are being appropriately rewarded, enables you to assess the true costs and benefits of investing and working for yourself and compare those costs and benefits with investing and working elsewhere. This also means you can therefore assess if, and how, taking more out of the business is appropriate, or if the business needs to be generating more so you receive sufficient returns for all your investment and hard work.

8 Steps to Taking Wages and/or Profit

Wages – Calculate Time Reward

Step 1 â?? What do you Do?

It might be hard to actually work out exactly how much time you spend wearing each of the above four hats daily, or during a single week. BUT if you look back on the last year, overall, you can most likely work out a rough average that splits up how you spend your timeâ?¦

Step 2 â?? What are you worth?

Take these rough averages and for the time split from Step 1 and establish what you would pay someone else to do the worker, manager and director roles for you. Donâ??t forget to include overtime, sick leave, holiday pay and all the other benefits that your staff get (the things you most likely never take). The calculation should show less for worker wages than manager wages, and a bit more for director wages â?? added together this will constitute a competitive Wage for your overall time.
NOTE: Think about it in terms of if you were sick what would you need to pay the three part-time people needed to fulfill each role in your absence?

Step 3 â?? What is appropriate?

a) Measure what your current Wage is by adding up what you receive from your pre-tax business profit each year in drawings, perks, superannuation, salary etcâ?¦ You donâ??t have to show anyone but yourself so be extra honest and include all those “Bunnings” purchases you took home â??accidentallyâ?• and any â??business lunchesâ?• you might have had â?? donâ??t under-estimate the rewards you really take by leaving this out.
b) Compare what you take in Wages against what you are worth from Step 2 above.

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Profit – Calculate Investment Rewards

Step 4 â?? What do you Do?

There are two sorts of rewards you can receive from your Investment because there are two sorts of returns:

- **Profit:** the result of normal business operations.
- **Capital Gains:**the result from selling the business

Step 5 â?? What is at Stake?

Consider how much money you have invested in you business, loans at start-up, money to buy stock & equipment, profits reinvested, being a guarantor etc etc Add up all of these to get a total and then work out a reasonable annual interest payment for making this investment. If you are not sure what â??reasonableâ?• is, use your current annual credit card rate as a guide and multiply that by the amount you have invested into your business.
NOTE: If you have borrowed money FROM the business, as well as investing money into the business, then offset any loans TO you against any loans BY you to get to a net total before calculating the interest.

Step 6 â?? What is appropriate?

a) Measure what you make by: adding up what you receive from your post-tax business profit in dividends, and interest paid by your business to you for loans and investments madeâ?¦ Plus take a rough guess at how much the value of the

business has grown over the same time and add the two together to find your total returns.
b) Compare the total returns against what you could otherwise get if you put the same investment in the bank.

Important Considerations to Taking Profit or Taking Wages

This is not Tax Advice:- How your accountant ‘massages’ the final numbers at year-end to optimise your tax positions will differ from country to country and personal circumstance to circumstance. BUT whatever the tax strategy it is not an alternative to good business management – you should always run your business to generate adequate returns for all your time and all the investment risk you are devoting to your enterprise.
Short term v long-term gains:- Not all of the annual profit has to end up as cash in your back pocketâ?¦ It may be appropriate to trade-off salary or dividends now for capital gains later, so long as the overall picture improves. This trading-off short-term gains for longer term capital gains may also be a very good reason to â??underpay yourselfâ?• when considering your annual budget.
Non-Financial returns:- The joy of doing what you love and the freedom to manage yourself is a very valid non-monetary return business owners gain. Being such a personal consideration it is difficult to factor a value on this, however it may be sufficiently large to justify ongoing low returns.
Critically, all these considerations and trade-offs needs to be measured and monitored to ensure running your business remains worthwhile year-in and year-out.

So, Wages or Profit?

The correct answer is probably both, if you own, invest and work in your own business.. But the practical answer may be slightly different.

Step 7 – Plan to pay yourself every cent you are worth

When planning and budgeting start by including the totals you have calculated for ALL your time, investment money and non-financial contributions into the bottom line in a really transparent way. The transparency enables you to then CHOOSE to pay a wage covering any portion of your time, or 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, or take some extra tax effective measures etc etc. There are countless decisions to swap and shuffle things about to suit your own world, and optimise your taxes.
Irrespective, your business should be **at least as rewarding** as working or investing elsewhere; so if cash-flow dwindles or alternative investment opportunities arise you need to know where you stand, and exactly what is going on because the fact remains you took a gamble by going into business! Without fully understanding ALL the costs, if you exclude your own time and contributions to â??boost his bottom lineâ?•, how will he ever know if you are winning the bet?

Step 8 – More is fine

If your business is very profitable and generating more than enough to cover your time and a good return on investment by all means go ahead and take more profit. Unfortunately in the SME space, I see this all too rarely so the article has been slanted accordingly.

What are your thoughts on this Wages versus Profit Dilemma?

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