

**EPISODE 564**

[INTRODUCTION]

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**FT:** You're listening to So Money every one. Welcome back, I'm your host Farnoosh Torabi, hope you're doing well, April 5<sup>th</sup>. Imagine selling two multimillion dollar companies, becoming an angel investor, I mean, you're pretty much early retirement here, right? But, losing it all. Losing every single penny. That's exactly what happened to our guest today, he's a serial entrepreneur, determined to figure out how to grow a healthy and strong company.

He started all over again, which led to his famous profit first formula. It's a way for businesses to ensure that they're going to be cash flow positive and that they're going to have money to survive. Now, Mike is running his third multimillion dollar venture, he's a former small business columnist for the Wall Street Journal, an author of the new book in its second iteration, *Profit First: Transform your business form a cash eating monster to a money making machine*.

In our conversation, we talk about the wrong way many businesses crunch their numbers and Mike's very simple but profound switch that can help you start generating more money. Then hitting financial rock bottom, having to confess it to his family, and the unforgettable move his then nine year old daughter made at that moment when he was confessing and crying and feeling just terrible that, he says, inspired him to turn his finances and ultimately his life around.

Here's Mike Michalowicz.

[INTERVIEW]

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**FT:** Mike Michalowicz, welcome to so money, very great to have you on the show. Congrats on the republication of *Profit First*.

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**MM:** Thank you so much, thanks for having me on your show.

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**FT:** Absolutely. Repub, let's share with the audience the good news, you published this, self-published this book and then a publisher came and said, "We love what you've done with this book, we want to take you on and actually do this book again with you." How does that work, just out of just my own curiosity?

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**MM:** Yeah, what happens in the technical aspects, I already worked with penguin, I wrote a book called *The Pumpkin Plan* with Penguin and they then have what's called a first writer refusal for any subsequent books and I told them about this concept, *Profit First*, and they were like, "Oh, an accounting book? No one wants that."

I said yeah, "I think you're right, no one wants it, I'm going to self-publish it." He said, "Okay." So we came to an agreement on that and self-published it and it's been by far my most successful book and the great irony is it's not an accounting book.

Fast forward two years after self-publishing it, I got a call from penguin, they said — It's a different person there so they didn't say, "Oops, we made a mistake." They said, "Hey, we're really — your book is really crushing it out there. We really want it, let's talk."

So we negotiated it, but it also gave me an opportunity to revise and expand the book to add stories now, success stories of businesses that have used profit first and to fix a couple of things that were quirky in the first version and now the book comes out February 21<sup>st</sup> this year.

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**FT:** Fantastic. Let's talk about the book. The premise basically is that for generations, many business owners have been using standard accounting principles, sales minus expenses should equal your profit, but you basically turned that around and said that isn't actually a successful way to run your business, it's why so many businesses run themselves into the ground. So tell us your counter argument to that.

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**MM:** *Profit First* is actually about the behaviors we have around money so it's actually a behavioral system. What is flawed with accounting is it is a logical system, it makes sense, sales minus expenses equals profit, we've all been told that. You have to have your revenue, you take away whatever expenses you incur, what's left over, what remains is profit.

But behaviorally it's the worst thing because when we put something as a remainder or a left over, it means it's insignificant. Subconsciously we just disregard it and how it plays out in our finances is everyone is looking for sales, it's the first thing in the formula. So sell, sell, sell. Then expenses we look at next and we call expenses, we call it growth.

So, investment, "Sell, sell, sell, buy, buy, buy. We've got to grow, grow, grow," and then profit, it's something we literally look at the end of the year saying, "Oh, are we profitable?" And our account says, "Oh, well not this year, maybe next." Or our accountant says, "Oh, you have a \$15,000 in profit," and we say, "Well where is it?" Then the accountant says, "Well, you don't have it, it's an accounting profit, there's really nothing in your bank account." Then we say, "Dammit, maybe next year."

In *Profit First*, we flipped the formula because when we put something first, we prioritize it. I would never come out of the hospital after a health scare and say, "Now I'm going to put my health last." I say, "Now I'm going to put my health first." What we do in *Profit First* is sales or what drives businesses, so it's sales minus profit. So you have the sales then you subtract your profit, it's the pay yourself first principle basically, applied to business.

You take a percentage of those sales immediately stored to our profit and then the remainder is expenses. While this is a simple shift to do technically, the effect on the business is profound.

We now are reverse engineering our profitability. So you predetermine the profit percentages you intend to achieve and then you are forced to make sure your business works within parameters that can actually achieve those profits.

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**FT:** I mean, it makes total sense to me because like you just said, it's very parallel to the personal finance principle of pay yourself first. Why would we pay our businesses first? How come this hasn't been more widely practiced? Why are you the one to turn the light bulb on for everybody else?

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**MM:** I don't know, well I do know why I did it, it's because the old formula wasn't working for me. The system has been around forever, so it's not like I invented something. This is the pay yourself first principle, we've been told to do in our private lives. Everyone, not everyone, but many people are aware of when money comes into your personal life, proactively reserve money for your retirement to pay yourself first. Reserve money maybe for that vacation you want and then live off of the remaining money and it works.

The books like, *Richest Man in Babylon*, *Think and Grow Rich*, I mean, there are so many books dedicated in part to this concept of prepaying ourselves. I just realized, "This works for me personally but why am I not doing this in my business?" So I started doing it there. I don't know why anyone else, no one else thought of it prior or applied it prior but I switched the principles and sure enough, my business shifted and it wasn't like over time, it shifted instantly.

I started seeing my business in a whole new light, profit started sky rocketing for myself and it brought a new sense of stability in my business life. I say, I make this into a book. I don't know why in the first — I know I needed it for my own business because I couldn't do the accounting. I tried to. I tried to read the income statements and balance sheets and cash flow statements, I just never could comprehend it. I'd always resort to just looking at my bank balance and then taking actions based upon what I saw there.

So *Profit First* allows me and everyone that does it to continue that normal behavior of logging into your bank accounts but now that you have multiple bank accounts set up at your bank. That's the second part of it, it's like an envelope system. Now you have multiple accounts up your bank, perhaps one for profit, one for paying yourself a salary as an owner, maybe one for buying materials or inventory, another one for just the general operating expenses. Now that you see money reallocated to this different accounts, you know exactly what's available for what purpose before you spend the money.

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**FT:** What's a good profit percentage? I mean, because look, some people might go, "I want to make 50%." What's realistic so that you can at least still make your expenses too? I understand that expenses will probably have to adjust once you retool this equation to pay yourself first, you'll have to probably make some concessions with your expenses and become smarter about how you spend on whatever you need to do to operate the business, but going back to *Profit First*, what's a good bench mark for profit?

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**MM:** What I did was I studied a thousand companies, fiscally elite companies for their industry. So I looked at every industry manufacturing to membership organizations to service businesses, professional services like law firms and so forth. Found that in every industry, there are companies that are fiscally elite. They are the best performers in the industry. What I found is, and this is obvious, they don't perform at the industry average.

Many people can compare themselves to the average, which by the way makes no sense. That's like saying, you know, "What's the average grade for a student, I want to aspire to be average. C is the average grade, I want to aspire to be a C student. Or as an athlete, I aspire to be the average athlete." We would never say that in those settings yet so many businesses say "What does the industry do, I want to achieve the standard of the industry."

So instead, I looked at the fiscally elite and I found that based upon different revenue ranges. Brand new startup for example, that may be is one employee generates under \$250,000 in

revenue versus a company that does maybe one million or five million. I put them in different revenue categories, put the numbers of the physically elite and small businesses, a micro busies where it's just the owner operator themselves, they're throwing off 10, 15% profit, they're throwing off another 30 or 40% to pay the owner themselves. So owner pay is a salary, your regular conversation, profit is that yearend bonus that comes to you or I suggest stir everything on a quarterly basis and then even this reserve taxes on your behalf.

When that tax bill comes at year end, the business has allocated that money on your behalf in advance so you don't have to pay out of your own pocket. The remainder is maybe 20% for operating expenses in those micro businesses. Conversely, one million dollar business, a really healthy one, it may be doing 15% in profit, another 20% to owners pay, another 15% to the taxes and then the remaining 45% or 55%, whatever it is went into operating expenses.

What I did was I created a chart, which of course it's in the book, of all this different categories so you can see what the physically elite do. I also have that for free download off my website so you don't have to buy the book but I studied it. What I found is, it's a mistake for us as business owners to say, "Hey, what's my industry do on average? I should aspire to have that." If you do that, you're just going to be an industry average player and you're not going to find innovative ways to achieve that new profit.

The end lesson is this, by taking *Profit First* you are reverse engineering that profitability. So we want to target over time, an industry breaking profit standard and then we'll become an industry world breaking business.

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**FT:** I love that. You come to this, you kind of touched on this that you kind of learn from your own experiences; you sold two multimillion dollar companies, you became angel investor and then you kind of lost it all.

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**MM:** Oh, everything yeah.

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**FT:** Everything. Take us to that down point, to that rock bottom place, what happened? What went wrong?

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**MM:** Yeah, so what went wrong was me and I realize I was fundamentally flawed from the get go and I haven't changed in how I behave. I don't think people can change, but I changed the systems around me so my bad behavior now becomes a good behavior. What I did was I thought profit was an event, that profit came at year end and that I had to grow and constantly focus on growth and that one day, profit would happen, made it the end of the year or maybe when a major client came in or maybe an investor?

There was this trigger point, that's how I grew those first two businesses and my beliefs were validated when I sold those companies, one was acquired by private equity, one was acquired by a fortune 500 and I was convinced then, you just build it by hook or crook, you spend every penny you have and one day someone will buy you. I'll do it on steroids, why don't I start 10 companies simultaneously as an angel investor, except for my own money in this company started them all and they all, except for one, they all collapsed within six months.

I remember, I was paying bills for companies that didn't even exist and simultaneously I was blowing money too in my personal life, I need to have trophies like cars and big houses and I got to have a sabbatical in Hawaii. Just living large and it took me two years, I blew literally every penny I had and went into depression, not deep depression but functional depression for two years, started drinking more than I should and I'm not really a drinker, and just insomniac.

It was during this period that it was ugly but it also sparked a reinvestigation of my own life and my understanding of different principles I thought were true. The big one was that I came to realize profit is not something that is an event, a future thing, it's a habit. Profit needs to be baked into our business, every transaction, every day, every moment, we would need to make

small but consistent incremental movements toward more and more profitability. Profitability brings about sustainability, it brings about true confidence.

I talk about the top line, the bigger my revenue is, the better but that's a vanity number, there's a saying, revenues vanity profit is sanity. Revenue is an ego oriented number. Profit is a health oriented number, it's a stability, it reduces stress and so now, what I'm trying to teach others and I've employed for myself is that let's not focus on the top line. Let's focus on the profit line, the bottom line.

Let's grow that and the stability there and ironically, the more focused we are on profit, we have to become more selective in what we do, offer profitable products and services with the focus of clients that we actually become more masterful because now we're doing fewer things for fewer people better.

We've become masterful in what we do and the greatest irony of all is that it sparks the fastest growth. I started a new company today, it's my fastest growing business out of all my businesses and it's because I focused on *Profit First* from day one.

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**FT:** To hear your story, it's almost like you're not shy to risk but at the same time, the *Profit First* equation is very kind of risk averse. But being that you're a serial entrepreneur it's like if I failed at two businesses, multiple businesses, lost everything, I don't know if I would go back to entrepreneurship but that just proves that you were meant to be doing what you're doing.

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**MM:** Yeah, thank you. Yeah, risk has never really frightened me. The not doing something is actually what gives me anxiety, idleness, having an idea and not testing it out. So many things I do fail. What I say by fail means, I don't get the result I want. With my businesses, I realize that continuing a failure is not good either. Yeah, this businesses grew but to repeat again, a growing business that makes no money, the stress is just overwhelming. So I had to find a new way and I've been living profit first for 10 years now.



Consistently profitable, day in, day out, year in, year out. The irony is this, my accountant is like, “How do you do it?” He doesn’t share the exact client details but he has hundreds of clients and 80 or 90% of the, them are surviving check by check. He’s like, “What’s the solution?” and the key irony is it’s not the accounting, you’ve been telling me the income statements and all of that stuff for years, it ain’t that.

The system I use, allows me to continue the exact same behavior of logging into my bank accounts and seeing what’s there. That’s the only shift but the effect is profound because as I already said, it starts forcing you to reinvestigate your business and focus on only the things that bring health to your business.

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**FT:** Tell me a little bit more about Mike Michalowicz growing up? What’s your childhood like and do you find that it set you up for the current life you have now financially and entrepreneurially?

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**MM:** The Mike Michalowicz growing up could be defined in one word; Nerd. I was a big nerd.

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**FT:** Weren’t we all nerds though? I mean, unless you were like homecoming king and queen.

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**MM:** Yeah, touché. This gangly, nerdy kid and what I look back a couple of things have come out of that period of my life that just kind of defined me was, I was the weakling, I was the 10 pound weakling and in the school days, you know, boys are boys and some fist fights in and different things happened, I was a guy that — there was no way I’d ever win something like that so I always avoided it.

You can only avoid it for so long unless you find humor. If you can be the jokester, the funny guy that there was kind of safety in that. One part of my character as a kid, I always liked to joke around but as I kind of peeled back the onion myself and said, that was my safety mechanism, as a protection mechanism, the funny kid.

In my adult life, that's played out that self-deprecating humor, maybe using as a protection mechanism, I am, but additionally, it's a good way to connect with others. I feel that we're all on a kind of a continuum of life and while some of us will have extreme success and extreme failure, we're going to all have experience at different phases of our life.

Therefore, regards of your current circumstances, we're all equal. I believe that to the core of my soul and therefore, in my adult life too, I don't see myself as better or even more educated or more knowledgeable by anything.

I just see that I'm in a different part of my continuum and I'm sharing that and hoping and I find that others actively share their part of their continuum. Those are some lessons that kind of came out of my childhood and have supported me in spreading the word and hopefully serving others.

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**FT:** Yeah, when you're the nerd, it kind of creates this sense of empathy for others that as an adult, it's such an asset you know? To have.

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**MM:** I want to fight...

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**FT:** Yeah, you want to fight for the underdog.

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**MM:** Basically, that's exactly it and the only tweak guys, I don't want to fight for the underdog, I'm going to fight with the underdog. I feel that as much as I need — I need to have confidence and serve myself, I believe that's true for all of us but I also realize just to stand up one day and say I'm making my stand and drawing that line in the sand is hard so my philosophy, I want my arm over your shoulder, if that's the way you feel and fight alongside you but empower you to stand fully on your own.

My definition of it is entrepreneurship. There's so many facets of life where I think we can help others. Mine is just in the entrepreneurial space because I've been there, I've continued to be the underdog myself, I found tools to stand up on my own and I hope these tools serve others to do the same.

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**FT:** Well, we kind of went through your biggest failure, is there something else that maybe we should know about? Did we miss something?

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**MM:** I'll tell you this about the biggest failure, those turning moments. The moment before I lost everything. I mean this was literally the last second, I got the call from the accountant. He said, "You got nothing left you should file bankruptcy," and gave me the outline of what to do and I didn't have enough money to pay my taxes. I actually asked him I said, "Keith, what happens when you don't pay your taxes?" He goes, "Well, you go to jail," and I think he thought I was probably kidding but he said, "You go to jail so we have to put you on an instalment plan," which was the worst.

But the moment then was I came home to my family and I'm ashamed of this but I share this because I think it's important for others to hear. I went home to my family and up to that point I had been admittedly lying to my wife and to my children, telling them that everything is okay when it was a train wreck, when I was a train wreck and losing money and that day I could not propagate the lie any further. I couldn't say, "Everything is fine."

I had to say, "It was all gone," because it was. So we are losing our house, our cars, my daughter's horseback riding lessons. It cost \$25 every two weeks could no longer be afforded and I remember I'm sitting there ashamed of myself crying and sobbing in front of my family telling this. They were shocked and my daughter, nine years old at the time ran out of the office to go to her bedroom and I thought that she was just running away.

And I also thought that that was the solution was to run away but she wasn't running away, she actually ran to her room to get her piggybank and she came back down to our kitchen table, put it down and said to me, she said, "Daddy I'm going to support us," and that was the turning moment. That I felt such honor and pride in my daughter, such strength from her, such commitment and I also realized that everything was lost then.

I was ashamed and embarrassed of myself, my ego, my arrogance but that there could be a fresh start and listen, it took two more years. It wasn't like the next morning I sprung out of bed and said, "Oh! ml found the solution," no. I went through depression but also that was the seedling for change and realized that for us, all of us to get through this world whatever challenge we are facing, we need the support and help of others and we need to contribute to others.

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**FT:** That's such a great story. I often ask guest what's your So Money moment, I think that was it because it's just a reminder. Your children, such a mature daughter you have. She could have run away and never come back which is what you thought she was doing and that would be a totally healthy normal reaction probably for a nine year old because it's a lot of take in but instead she wanted to step up to the plate and be your champion. So that is very much indicative of your parenting style and so that's priceless.

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**MM:** Thank you. Yeah, that was a life changer and that today, at her office, she's literary one re-mover for me right now working away. Her 19<sup>th</sup> birthday is approaching so.

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**FT:** Oh that was 10 years ago, my gosh.

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**MM:** It was 10 years ago, isn't that unbelievable? And it's funny, I was driving her to college and we're talking on the way and I said, "Hey" and this was only about two years ago I said, "Do you remember that day when you brought the piggybank down?" That day and I mean this, it will literary be my final thought before I leave this world. In my final breath I know I will remember that moment because it was so vivid.

And I said "Remember that?" and she looks at me and she says, "What are you talking about?" I'm like what do you mean what am I talking? She doesn't remember anything and my heart sunk for a moment saying the most important day of my life she's doesn't remember but then I realized to her that was the natural response. This is her character. She does that for everybody, every situation, she puts herself out to support them.

And that's now become the most impactful thing is that you know what's our true character? It plays out so naturally that others don't even realize I mean that we don't even realize that as significant or important but the impact we can have on others when we're truly our self can be profound.

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**FT:** Well said and so what is a habit that you practice in your personal financial life Mike that given all the trials and tribulations that you've had, what is something that you now have learned from that that you practice, and we know what you practice in your business but how about in your personal life?

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**MM:** My business translate to my personal life. I have multiple accounts for my business, my home finances, I always have personal accounts. So we have our vacation account. We are actually going to the beach soon, already all been paid for in cash because there's a vacation account and we already have next year, the 2018 vacation account already accumulating and reserved. We have a wedding account.

My daughter is 19. I'm not hoping she gets married soon, I hope she takes her time but when she's ready to get married, that money has been reserved for her. We have an emergency fund because I don't know what's around the corner and maybe tomorrow my finances fall to the ground but we have now money reserved and I'm also debt free. That's probably the biggest thing. I have no single credit card debt, no car loans, no debt, no house loan, all paid.

All paid but the important thing is that's the result of a discipline of over 10 years, right? It's not like I was debt free. Actually I was wallowing in personal debt 10 years ago. I remember I had over \$50,000 of just credit card debt and on the radio I was listening one day and I say, "Oh the average American has \$4,000 of credit card debt and saying to myself, "I've never so badly wanted to be average."

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**FT:** Yeah, right.

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**MM:** So the process has been chipping away, chipping away, chipping away and one little last tip I want to share, I learned this from Dave Ramsey, the author of the *Total Money Makeover*, a fabulous book on personal finance and in his book, he explains his concept of the snowball effect that when we ware wallowing in debt, and have all this different debts to instead of go after the highest insurance rate which makes logical sense by the way to instead go after the smallest debt first and eradicate it because when we get that first debt off, even if it's like a hundred bucks loan to a friend.

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**FT:** Feels good.

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**MM:** Feels good, you got to tear up that statement. So that's how we did it. I started to go after the small steps first and the last I paid off was the big one and it's done, it's gone and it just... every time I write up a statement, I'd be embolden, I was excited because the statements were dubbed and that payment I was making toward that small debt now gets added on to the next debt in line where I'm already making some payments, the minimum payment.

Now I'm adding more financial power behind it because I eradicated that first, it builds this kind of snowball, this momentum and that was a big tool for me in my personal finances.

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**FT:** Well, I think with any book that has to do with money or business, it's not just the ones that are successful and the messages that are successful have not just to do with the fact that well, the math adds up in this book and so clearly, it's logical it will work for you but then it has to really speak to our minds and our behaviors and that's what you do so well and why Dave Ramsey does so well and why not surprised that profit first is now experiencing a second life, congratulations Mike.

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**MM:** Thank you so much.

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**FT:** By the way everybody, Mike has many other books which have also equally funny great titles, the pumpkin plan, the toilet paper entrepreneur, surge, so check out [MikeMachalowicz.com](http://MikeMachalowicz.com) and hope your daughter doesn't get married any time soon.

[END]