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Profit First

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

THE SUMMARY IN BRIEF

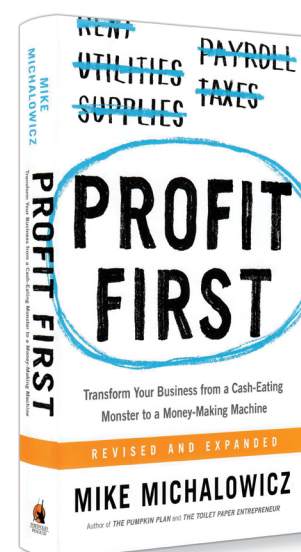
What if, rather than you serving your business, your business served you? What if you could turn a profit from your very next deposit? And what if you had the power to guarantee that profitability?

It's possible, and the solution is simpler than you think. Mike Michalowicz, the author of perennial bestsellers *The Pumpkin Plan*, *The Toilet Paper Entrepreneur* and *Surge*, has developed a counterintuitive cash-management system that has helped tens of thousands of small businesses break out of the doom spiral and achieve instant profitability. Now, you can do it too.

Treating profit like an afterthought, secondary to growth, usually has the effect of running your business into the ground. *Profit First* takes a behavioral approach to accounting and flips the formula: **Sales - Profit = Expenses**. Just as one of the most effective weight-loss strategies is to limit portions by using smaller plates, Michalowicz shows how to take profit first and spend only what remains on expenses. With this one change, you will instantly transform your business from a cash-eating monster to a profitable cash cow.

IN THIS SUMMARY, YOU WILL LEARN:

- Why following four principles can simplify accounting and make it far easier to manage a profitable business by just looking at bank account balances.
- How taking your profit first both enforces frugality and inspires industry-changing innovation.
- That a small, consistently profitable business can be worth much more than a large business that struggles to sustain itself.



by Mike Michalowicz

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THE COMPLETE SUMMARY: PROFIT FIRST

by Mike Michalowicz

The author: Mike Michalowicz launched and sold two multimillion-dollar companies and is the co-founder of Profit First Professionals, a membership organization of accountants, bookkeepers and coaches who teach the Profit First method. He is a former columnist for The Wall Street Journal, and is a popular keynote speaker who has shared his insights on business and entrepreneurship at TEDx, creativeLIVE, INCmty and others. He is the author of *The Pumpkin Plan*, *Surge* and *The Toilet Paper Entrepreneur*.

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Your Business Is an Out-of-Control Cash-Eating Monster

No 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 businesses that survive are racking up debt, and their leaders are perpetually stressed. Most entrepreneurs are living a financial nightmare.

Stitching together a business with nothing but a great idea, your unique talents and whatever few resources you have at hand is 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.

No amount of talent, ingenuity, passion or skill will change the fact that cash is still king. Master the essence of financial security: Save your money and block access to it so it doesn't get stolen — by you.

Bigger Is Not Better

Growth is the battle cry of nearly every entrepreneur and business leader. But growth is only half the equation. Most business owners try to grow their way out of their problems by hinging salvation on the next big sale or customer or investor, but the result is simply a bigger monster.

Entrepreneurs assume that at a certain point, their revenue will yield a profit. Profit is always within sight but never attainable. What they don't realize is: Profit is not an event. Profit is a habit. ●

The Core Principles of Profit First

Quick fixes for weight loss don't work and aren't sustainable. What we really need are simple *lifestyle* fixes that change how we eat without our even really noticing. For example, use smaller plates.

If you reduce the "plate size" of your business's operating account, you will spend differently. So rather than curb your spending habit, create the experience of having less cash on hand than you actually have and then find ways to still make things work.

The Four Core Principles of Profit First

- 1. Parkinson's Law.** In 1955, a modern philosopher named C. Northcote Parkinson came up with the counterintuitive Parkinson's Law: The demand for something expands to match its supply. In economics, this is called induced demand. The more we have of something, the more we consume. You need to intentionally make less money available to operate your business. When there is less, you will automatically run your business more frugally, and you will run your business far more innovatively.
- 2. The Primacy Effect.** We place additional significance on whatever we encounter first. When we follow the conventional formula of Sales - Expenses = 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



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to pay bills, over and over again, wondering why we never see any profit. When profit comes first, it is the focus, and it is never forgotten.

- 3. Remove Temptation.** 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, 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.
- 4. Enforce a Rhythm.** When we get into a rhythm, 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. 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. Instead of reading the cash flow statement, you can measure your cash flow by just checking your bank accounts.

But If I Set Aside My Profits, How Will I Grow?

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.

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, 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.

The New Accounting Formula

The next step is to put a system around the normal you. And we start with a simple, new Profit First formula:

Sales - **Profit** = Expenses

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.
- 2. Serve Sequentially.** Always, *always* allocate money based on 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 OPERATING EXPENSES (OPEX). 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 other accounts. It means that you can’t afford those expenses and need to get rid of them.
- 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” 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 10th and 25th). Don’t pay only when there is money piled up in the account. Get into a rhythm so that you can see how cash accumulates and where the money really goes. This is controlled by recurring and frequent cash-flow management, not by-the-seat-of-your-pants cash management. ●

Setting Up Profit First for Your Business

The Five Foundational Accounts

It’s time to take your first step: setting up your accounts. Here are the five checking accounts you need to set up:

1. INCOME
2. PROFIT
3. OWNER’S COMP
4. TAX
5. OPEX

Make sure you set these up as checking accounts, and name your accounts according to their purposes.

You can use your existing primary bank account as one of the five accounts. Rename it your OPEX account

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because you are likely paying all your bills from that account. Going forward, move deposits to your INCOME account. This includes check deposits, credit card or Automated Clearing House (ACH) payments. Update your bank information as necessary.

Two “No-Temptation” Accounts

Your next step is to set up two “no-temptation accounts.” Get your taxes out of sight and out of mind. Do the same with your PROFIT account.

Find a new bank that you have never worked with before. At the second bank, set up two savings accounts: PROFIT HOLD and TAX HOLD. Then link these two accounts to the respective PROFIT and TAX accounts at your primary bank so that you are able to transfer money.

Picking the Bank

At your primary bank, you want easy access to view your accounts, easy ability to transfer money from INCOME to your other accounts, and you want to be able to pay bills out of OPEX. At your secondary bank, you want no convenience options. Remember: out of sight, out of mind.

Some (but very few) large banks will work with you by cutting out the fees. But, many regional and local banks and federal credit unions will be thrilled to work with you, and in many cases, they don't have all those fees in the first place.

If you like your current bank, tell them that their requirements for a minimum balance and transfer fees don't work for you. Ask to waive the minimum balance requirement and other fees. If your bank complies, kudos to you. If not, move on to a new bank. ●

Allocation Percentages

Some entrepreneurs try to kick-start their Profit First system by taking a profit of 20 percent immediately. This is a classic mistake. However, there is a way to reach your goal.

The Target Allocations Percentages (TAPs) are simply the targets you are moving toward. TAPs are not your starting point. Aspire to move toward the TAPs, which can range from 5 percent to 20 percent depending on the size of your business revenues.

The Current Allocation Percentage (CAP) is where your business is today. This is the number you will adjust slowly but consistently over time to get closer and closer to the TAPs. For example, the Profit TAPs for your business size might be 20 percent, but your historical

profit allocations might have been 0 percent. If you haven't made profit allocations until now, then your profit CAP is 0 percent.

Perhaps you will never quite reach the TAPs to which you aspire. But they will force you to constantly think about what you are doing and how you are doing so that you can get closer.

Owner's Comp TAP

Owner's compensation is the amount you and the other equity owners take in pay for the work you do. Your salary should be on par with the going rate for the work you do, in other words, the salary you would have to pay your replacement.

Take a realistic look at the work you do. If you have a small company, you may call yourself the CEO, but that's just the title on your card. It's likely you are doing a lot of other work. In reality, about 2 percent of your time is doing the job of CEO: vision planning, strategic negotiations, acquisitions, reporting to investors, addressing the media, etc. Determine your salary based on what you are doing 80 percent of the time and what you would reasonably pay employees to do those jobs. Then, evaluate pay for all equity owners who work in the business.

Add up the salaries that represent your Owner's Comp draw. The percentage of revenue you set as your Owner's Comp TAP must, at a minimum, cover Owner's Comp draw. Make the percentage one and one-quarter times the amount you determine for your salaries, so you can adjust for revenue fluctuations, and be able to cover raises and bonuses.

Your Tax TAP

The first step in getting to your Tax TAP is to determine your income-tax rate. One goal of the Profit First system is that the company takes care of all forms of Tax responsibility. It's mandatory that you talk with your accountant so she can advise you on all the ways you and your business will be taxed.

Here are three different approaches for determining your Tax TAP:

1. Look at your personal and business tax returns Add up your taxes then determine the percentage of taxes you paid compared with your Real Revenue (Real Revenue = Top Line Revenue - Materials and Subcontractors). Do this again for the previous two years. Looking at your taxes as a percentage of Real Revenue for the last three years will give you a good sense of your ongoing tax responsibility.

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2. From your accountant, get your estimated tax responsibility for your business, year to date (YTD), and then determine your Tax percentage of your YTD Real Revenue.
3. Or, simply use 35 percent for U.S.-based businesses, and if you have a business in another country, use the average prevailing rate of taxes for an individual at your income rate as your tax number. ●

Putting Profit First Into Motion

Day One

1. **Tell your people.** Include your financial professionals in the implementation of Profit First right from the start. Pull the numbers and then, with your bookkeeper and accountant, do a projection for the year. Then, work in the PROFIT account percentage you want to start with. With buy-in from your accountant on the principles and processes of Profit First, you can systematically apply the method to your business. Your accountant will help you meet your Profit First goals and stay the course.
2. **Set up your accounts.** If you haven't already, set up your foundational five accounts at your primary bank (INCOME, PROFIT, OWNER'S COMP, TAX and OPEX) and the two accounts at your new no-temptation bank (PROFIT HOLD and TAX HOLD). Do *not*, repeat, *do not*, try to make a shortcut and just do this in a spreadsheet or in your accounting system. And absolutely do not try to do all of this in your head.

Now, you are going to add to the nickname for each account by adding the CAP next to the account name and also putting your TAP in parentheses. For example, if you are nicknaming your PROFIT account, and the CAP is 8 percent and the TAP is 15 percent, nickname the account "PROFIT 8% (TAP 15%)." This allows you to quickly identify what money is going where, and the ultimate allocation percentage you are trying to achieve. At this point, we have determined the TAPs for each account. But TAPs are simply the vision. TAPs are not where we start.

For your CAPs, we'll start at our Day Zero contribution levels (the historical percentages you were allocating to each category before implementing Profit First) for each account and then add 1 percent, which brings us to Day One of your Profit First implementation. If your business has never had a profit or if you sometimes had a profit

and sometimes a loss, your profit has been zero. Therefore, our easy Day One start for the PROFIT account will be 1 percent CAP, and we will bump it up as we start getting into our quarterly rhythm.

Continue to add 1 percent to your Day Zero Tax allocation and Owner Compensation allocation to create new CAPs. Even if your targets are much higher, start with what you've got plus 1 percent for Profit, Owner's Comp, and Tax. Then, reduce the Operating Expenses by the cumulative of the percentage adjustments you made to the other three accounts.

Why start with small percentages when you likely could do more? The primary goal here is to establish a new, automatic routine. The goal is to set up these automatic allocations immediately and then adjust the percentages each quarter until you are aligned with your target distribution percentages.

3. **Make your first distributions.** Look at your bank balance in your original primary account, which we have renamed your OPEX account. Then, subtract any outstanding checks and payments you have from that account. Transfer the remainder of the money into your INCOME account. Now, divide up the money in the INCOME account into all the other accounts based on the CAPs you set. You will see that a huge portion of your money is going to expenses. Over time, you will be motivated to reduce expenses, and perhaps even more importantly, you will find ways to increase your profitability via innovation.

Week One: Cut Expenses

Now that you are moving money into your PROFIT, OWNER'S COMP, TAX and OPEX accounts, you need to get the money from somewhere. There are only two ways to do that: increase sales and cut expenses. Increasing sales is doable, but it takes time. Cutting expenses is generally a very quick and easy process. Most businesses find it easy to cut 10 to 20 percent of expenses overnight, such as frivolous costs like unused, recurring membership fees, office space that impresses no one, an expensive car or perhaps even extra staff who aren't helping your cause much.

You have just accounted for at least 3 percent (1 percent in each of the PROFIT, OWNER'S COMP and TAX accounts) of your income, so you need to cover that by cutting 3 percent of your expenses. To do that, print out your expenses for the last 12 months and any recurring expense, such as rent, subscriptions, internet access, training classes, magazines, etc.

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Now, add up all the expenses and multiply that number by 10 percent. You must cut costs by 10 percent.

Why 10 percent when we only need 3 percent? Because it may take a month or two to pay down balances owed on the expenses you eliminate. More importantly, you need to start building cash reserves because by the start of the next quarter, you are going to move another 3 percent to your PROFIT, OWNER'S COMP and TAX accounts and then another 3 percent the quarter after that.

You can easily find your first 10 percent in cuts by doing the following:

1. Cancel whatever you don't need to help your business run efficiently and keep your customers happy.
2. Negotiate every remaining expense except payroll.

Twice a Month: The 10th and the 25th

By looking at your bills and deposits two times a month, on the same days each time, you can see a pattern. You'll see trends and understand your cash flow.

Here's how to get started:

Step One: Deposit all revenue into your INCOME account.

Step Two: Every 10th and 25th day of the month, transfer the total deposits from the previous two weeks to each of your five allocation accounts based on your CAPs.

Step Three: Transfer the full account balances for both your TAX and PROFIT accounts to the respective accounts at your second (no-temptation) bank.

Step Four: Take from your OWNER'S COMP account only what you have allocated as your biweekly salary and leave the rest to accumulate.

Step Five: Pay your bills with the money remaining in the OPEX account.

Note: There is a possibility that you will not have enough money in your accounts to pay bills or pay yourself. This should be a major wake up call. It is your business shouting out that you can't run your business the way you have been running it. You are spending more money than your business can support.

Quarter One

You are going to take a profit-distribution check every quarter. Don't confuse the profit distribution with Owner's Comp, which is pay for working in the business. Profit is a reward for owning the business.

Every quarter you will take 50 percent of what is in the account and leave the other 50 percent alone. If your company has multiple owners, the distributed profit is divided up based on the percentage owned by each equity owner.

The key is this: the profit distribution can never go back to the company. Your business needs to run off the money it generates in its operating expenses. So, always take your profit, every quarter, and use it for your own purposes.

Pay Uncle Sam. Every quarter, you will also pay your quarterly tax estimates.

One Small Step. Each quarter, you need to evaluate your current percentages and move them closer to your TAPs. You can move any percentage you want to get to your TAPs, but the goal is to never take a step back.

If you are adjusting and tweaking your percentages conservatively, it is suggested that you account for 3 percentage points each quarter. Meaning you could move your PROFIT account from 5 percent to 8 percent. Or you could move your TAX, PROFIT and OWNER'S COMP accounts up 1 percent each. And if you can adjust more, go for it.

Year One

Because you're in the quarterly rhythm of evaluating and moving closer to your TAPs, there isn't much of anything special you need to do on a yearly basis. The only thing you need to add to your financial management at year-end is the finalization of your taxes.

Determine how much you owe. If you owe more than you have in your TAX account, a few things likely went wrong. You didn't save a big enough percentage, or you didn't check in quarterly with your accountant to see how you were doing with your tax reserve.

If you owe taxes at year-end and don't have the money in your TAX account, this is the one time you can pull from your PROFIT account for a reason other than profit distribution. Adjust percentages in your TAX account to ensure you will have enough for the next year. ●

Destroy Your Debt

Even when you and your business are in debt, you must establish a habit of putting your profit first. When you get into a habit of fiscal health, you will fix the problem permanently.

The Profit First system's approach to dealing with debt is this: When you distribute profits, 99 percent of the money goes to paying down debt. The remaining 1 percent goes toward rewarding yourself.

Preparing for Your Worst Month

The trap entrepreneurs fall into is believing their most recent best month is their new normal. To prevent

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shortsighted behavior but stay optimistic, always look at your 12-month, rolling average income and related numbers. When comparing figures, compare your current month to the same month in the previous year.

Until your best month becomes your average month, it's not the norm; it's the exception. When you base decisions on your best revenue month, you will run out of cash — quickly. Debt will start to pile up.

The Debt Freeze

The following will guide your business through a rapid pay-down of accumulated debt and a freeze of new debt all while continuing your Profit First habit.

Print and Mark Up Documents

1. Print out your current income statement for the last 12 months as well as your current accounts payable report, your credit card statements, loan statements, any other statements related to debt and your last 12 months of payments made from any of your business bank accounts.
2. Go line by line through each expense (past and present) even if you are not incurring the expense anymore, and with a pen, mark the expense with a “P” for any expense that directly generates (P)rofit; “R” for any expense that, while necessary, can be (R)eplaced with a less expensive alternative; or “U” for any expense that is (U)nnecessary for delivering what you offer.
3. Review every expense, including salaries, commissions and bonuses for employees, rent for the office, equipment, health care, raw goods and your office Spotify subscription. Everything. If money goes out of the business, it needs to be categorized as “P,” “R,” or “U.”
4. Now, circle any expense that is recurring even if it happens to be in a different amount.

Now Let's Do Some Math

1. Add up all the expenses for the year. Exclude tax payments and owner's distributions or salaries. Now, divide that number by 12 to determine your monthly “nut” — the total amount you have decided you need to cover each month.
2. Determine the difference between your current monthly operating expenses and the number it must be according to your previously determined OPEX allocation.

3. Work out a plan to cut expenses until you are operating at 10 percent below the target number on your Operating Expenses TAPs.

If your company is racking up debt, it is all too often because labor cost is too high. You need to let go of people.

Evaluate each person and determine if her role is mandatory for operations to continue. Next, evaluate your staff members. If they aren't directly generating profit, they need either to be moved within your business to help it become more profitable, or they might need to be removed from the company.

Time for More Cuts

Now that the hardest part is over, call your bank to stop all automatic withdrawals from all of your accounts except for any expenses that directly generate profit. Then, notify your vendors that you are stopping the withdrawals and will pay by check going forward. This will make you acutely aware of every payment you make.

Call each of your credit card companies and ask that you be issued a new card with a new number. Tell the credit card company that no payments that were being processed on your old card should transfer to your new one. This step will stop automatic charges.

Next, cut any unnecessary expense listed. If you doubt whether you can really cut it, just cut it. An expense is always easy to add back. For the replaceable expenses, it is time to negotiate. Everything is up for negotiation – your rent, your credit card rates and debt, your vendors' bills, your software license, your internet bill, etc. ●

Find Money Within Your Business

Cranking up the sales team is not going to help your company if you don't have efficiencies in place because, ultimately, whatever new client revenue you generate will have corresponding costs. If you want to increase profitability, you must first build efficiencies.

Look at efficiency in every aspect of your business. Serving the same types of clients with the same or very similar problems and perfecting your solutions so you can use them consistently to fix their problems are two routes of efficiencies. You want to duplicate your best clients, those who have a consistent need; and in turn, you want to reduce the variety of things you do for the fewest that will best serve your best clients' needs.

Most entrepreneurs focus only on tiny improvements – “How do I do this a couple minutes faster?” Small questions yield only small answers. You want both the

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incremental improvements and the landslide discoveries, and you'll find both of those with big questions.

Fire Bad Clients

Letting go of clients who drain you and eat up your profit margins is a way to make space for clients you can serve exceptionally well by doing what you do best and with fewer resources.

Clone Your Best Clients

Think of your favorite client: The client who pays you what you're worth, on time and without question. Now, imagine that this client had five identical-twin companies that all wanted to work with you. Wouldn't that boost your business?

Having clients with similar needs and behaviors offers a few profit-making benefits:

1. You will become superefficient because you now serve very few but consistent needs rather than an excessive array of needs.
2. You will love working with your clones, which means you will naturally and automatically provide better service.
3. Marketing will become automatic. Your best clients hang out with other business leaders who have the "best client" qualities you're looking for. Your best clients will talk you up every chance they get. ●

How To Keep It From Falling Apart

The worst enemy of Profit First is *you*. The system is simple, but you must have the discipline to implement it consistently.

Common Mistakes

1. **Going It Alone.** Going it alone is the biggest mistake entrepreneurs make when implementing Profit First. Getting an accountability buddy will make sure you let the system work.
2. **Too Much Too Soon.** It is extremely common for entrepreneurs to start putting 20 or 30 percent into their PROFIT accounts right out of the gate. The next month, they realize they can't afford it and pull the money back out to pay bills, which defeats the entire process.
3. **Grow First and Profit Later.** Too many entrepreneurs believe that you can only have one or the

other: profit or growth. The healthiest companies figure out how to consistently be profitable first and then do everything to grow that.

4. **Cutting the Wrong Costs.** Not all expenses should be cut. Invest in assets, which are defined as things that bring more efficiency to your business by allowing you to get more results at a lower cost per result.
5. **Plowing Back and Reinvesting.** When you find yourself in a situation in which you feel the need to plow back your profits, stop to reassess. There is always a better, more sustainable way to maintain the health of your business.
6. **Raiding the Tax Account.** As your profitability grows, your taxes will, too. So don't steal from your TAX account thinking you won't need that money for taxes. You will.
7. **Adding Complexity.** The system has been designed to work with how you naturally work. Don't overthink it. Don't add complexity. Don't try to outsmart the system.
8. **Skipping the Bank Accounts.** Profit First at the bank will be in your face every time you look at the accounts, which enables you to manage profitability and cash-flow decisions in real time. Setting up your accounts means you can't avoid it, and that is exactly how it needs to be.

It's easy to fall back into the old ways because they seem to make sense (they don't), because your accountant says you shouldn't bother (you should), or because you think you were happier doing things the old way (you weren't).

To quote the great athlete Sir Roger Bannister, who broke the 4-minute mile, "The man who can drive himself further once the effort gets painful is the man who will win." ●

MORE SV CONTENT ON CREATING A SUCCESSFUL BUSINESS

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Summary: *The Pumpkin Plan* by Mike Michalowicz. Inspired by an article about how to grow a giant pumpkin, Mike Michalowicz modified the step-by-step approach to growing a business. Applying it to his own company, he created a multimillion-dollar industry leader.

Webinar: *The Most Common Mistakes Entrepreneurs Make* by MJ Gottlieb. MJ Gottlieb provides a highly animated, layman's terms presentation for aspiring entrepreneurs, putting each story in the form of a "case study" explaining both the crime committed ("The Wrong") and the lesson learned ("The Right").