

Multiple Checking & Savings Accounts

1

Which Profit First accounts should be checking accounts and which ones should be savings accounts?

It is important to understand the difference between a checking account and a savings account. As a general rule, savings accounts yield interest, but are limited in the number of withdrawals (usually 6) during the statement period (usually a month). A checking account typically offers an unlimited number of withdrawals and checks, but does not yield interest.

Option 1: Since Profit First encourages the 10/25 rule (allocate funds and pay bills on the 10th and 25th) for most businesses, **all accounts except for the Operating Expense (OpEx) account can be savings accounts.** Note that a savings account can't write checks, so Owner's Pay, Tax, Profit and other accounts won't be able to issue checks.

Option 2: Following the 10/25 rule, the Income account will accumulate all deposits until they are allocated to the Profit, Owner's Pay, Tax, OpEx and other accounts on the 10th and 25th at which time those funds will be used for those specific account's purpose. Therefore incoming funds "sit" in the Income account for approximately 28 days a month. Understanding this, **the Income account can be setup as a savings account (to accumulate interest) and all the other accounts can be checking accounts.** This will allow the most flexibility for withdrawals and writing checks, while accumulating the most interest.

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More bank accounts will result in a lot more bookkeeping work. Is Profit First really worth the effort?

The additional bookkeeping time required to manage and reconcile multiple accounts for Profit First is negligible, and possibly even more efficient than one using just one account. With Profit First you simply need to reconcile the deposits and periodic transfers from the Income account. All expenses and payment come from the OpEx account. And all the other accounts are typically a single transfer in on the 10th and another on the 25th, and a single transfer out at those times. It is easy to manage and reconcile. More importantly the Profit First benefits of instantly knowing what money is allocated to what purpose will have profound effects on the financial health of your business. No excuses. Set up the multiple accounts. Do it now!

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Which banks are the best and most flexible in terms of creating multiple accounts (e.g. Income, Profit, Tax, etc.) without charging fees?

Profit First readers have had great success with credit unions and community banks. Usually there are no fees and no balance requirements at credit unions, community banks and some regional banks.

As you setup multiple checking or savings accounts, some bankers will look at your crossed eyed (because most businesses don't do Profit First.... yet). Don't let that phase you, the banker simply doesn't understand the process. Just setup the multiple accounts and make sure that you won't incur fees as a result, even when your balance goes to zero in certain accounts at times. If the bank insists on charging fees and minimum balances, consider a different bank.

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In the book, it presents both basic and advanced Profit First systems. How are they different and which method is better?

The basic method of Profit First suggests establishing four accounts (Profit, Owner's Pay and Tax) in addition to keeping your current checking account for deposits and to pay bills. If three new accounts feels like too much, you can start with just two accounts: your current checking account and add a Profit account. **This basic method is a good way to "ease" into Profit First.**

The advanced method of Profit First suggests establishing minimally five accounts: Income, Profit, Owner's Pay, Tax and Operating Expenses. Additional accounts are suggested for specific needs (e.g. Payroll account for employees, a Drip account for distributing income over time, etc.). **The advanced method is the superior approach** since it separates deposits from any outbound cash flow (writing checks, etc.) and has additional accounts, making it very clear what money is available for what purpose.

The 10/25 Rule

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Why should I allocate money from the Income account to the Profit, Tax, Owner's Pay and OpEx accounts on the 10th and 25th instead of daily or as needed?

By doing the allocation process and paying bills twice a month (on the 10th and 25th) you benefit in two ways. First, doing this process every two weeks means you are doing it in a batch – which means you are more efficient. Secondly it gives clarity on cash flow trends. He will see the income accumulate and disperse, like waves in the ocean. When he sees trend changes it may indicate an overall change (problem or opportunity). Just like waves indicate the tides.

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Can I make allocations more frequently or on different days than the 10th and 25th?

Yes. Profit First was designed to be flexible, yet the 10/25 rule is a best practice. The 10th and the 25th are good dates because it achieves a semi-monthly rhythm of accumulating money and then allocating (the cash flow wave). Additionally when bills are paid on the 10th and 25th they arrive at vendors by the 15th and end of month, respectively. This is when bills are typically due.

But for some businesses a weekly rhythm is better. In that case, select the day of the week (e.g. Monday's) to allocate funds from the Income account to the allocation accounts.

Avoid doing the allocation process more frequently than once a week or ad hoc. A highly frequent rhythm or sporadic rhythm makes it difficult to observe the cash flow waves coming and and out of the Income account.

Real Revenue

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What is the difference between Total Income and Real Revenue?

Total Income is the top line revenue of a business. It represents all cumulative sales. Real Revenue is the Total Income minus the cost of materials and subcontractors.

A business should only adjust to Real Revenue for Profit First purpose if a significant portion of the operations requires materials and subcontractors (typically more than 20% of Total Income). The rule of thumb is if you are a service based business with full time and part time employees do the Profit First process based on Total Income. If you are a manufacturer, retailer, restaurant or a service provider that delivers the significant portion of its services via subcontractors you need to do the Profit First Process based on Real Revenue.

Please note that Real Revenue is similar to Gross Profit, but is not the same.

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What does Real Revenue mean?

Real Revenue is a term we use in Profit First to show an entrepreneur that their top line revenue (Total Income) is not truly representative of the size of the business. For example, a home builder may have \$10M in annual revenue and to complete their projects require materials and subcontractors that cost \$7M a year. That this means is that the company really has \$3M of “real revenue” and manages another \$7M of transactions (effectively moving money from the customer directly to the purchase of materials and the cost of subcontractors. This business needs to operate like a \$3M company and not a \$10M company. The term Real Revenue is used to make it very clear that the entrepreneur really has a \$3M business.

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Is Real Revenue the same as Gross Profit?

No. Gross Profit is the total revenue minus Cost of Goods Sold (COGs). COGs can include materials, subcontractors, employee labor, project costs (e.g. project related travel), and ancillary costs (e.g. shipping costs).

Real Revenue is a simpler calculation and less subjective. It is total revenue minus materials and subcontractors. Period. You do not subtract any labor of full or part time employees or other costs.

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My business requires that I run Profit First based on my Real Revenue. How do I manage the deposits from Total Income?

If you are making a Real Revenue calculation, that means you have material costs and/or subcontractors. In this case you need to set up two additional bank accounts: 1. Materials & Subs; 2. Total Income.

All your deposits from sales go to Total Income. Next, you take out the normal percentage of your Mat & Subs and move the money to the Mat & Subs account. Then the remaining money in the Total Income account goes to your "Real Income" account (formerly name the Income account) and then you allocate the Profit First percentages from that Real Income account.

The opportunity to improve your company's profitability is now achieved in two ways: 1. Reducing the amount spent on Materials & Subcontractors, which will flow more money to Real Revenue. And reducing Operating Expenses which will free up more money for the Profit, Owner's Pay and Tax accounts.

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Please give me an example of a business that needs determine their Real Revenue.

Let's look at an electrical contractor.

For this example, let's use simple round numbers and say the contractor has \$100,000 in Total Income. He spends \$30,000 in materials (cables, outlets, etc.), \$25,000 on subcontractors (another electrician he hires for certain projects), \$11,000 on an internal administrator, \$9,000 on vehicle costs, \$8,000 on rent, and has take home pay of \$15,000, has taxes of \$2,000 and has never had a profit.

This means that 55% of the Total Income (\$100,000) is being used for Materials & Subcontractors (\$30,000 + \$25,000).

So, when deposits come in they would go into the Total Income account. Then on the 10th and 25th, 55% of the Total Income money would be allocated to the Material & Subs account (that money would be used to purchase more materials and pay subcontractors). The remaining 45% would be allocated to the Real Revenue account.

Then the Profit First allocations of Profit, Owner's Pay, Tax and Operating Expenses would be allocated from the Real Revenue account. For this example let's say that the allocation percentages match the Target Allocation Percentages (TAPs) specified in Profit First for a business under \$250,000 in Real Revenue. That means 5% goes to Profit, 50% to Owner's Pay, 15% to Tax and 30% to Operating Expenses.

Based on \$45,000 in annual Real Revenue, the Profit allocation would be \$2,250, Owner's Pay would be \$22,500, \$6,750 reserved in the Tax account, and \$13,500.

With \$11,000 going to an admin plus \$9,000 to vehicle costs and \$8,000 to rent (a total of \$28,000) this business needs to clearly cut costs and run smarter. Costs need to be \$13,500 annually.

The other opportunity to make more profit (and owner's pay) is to reduce the Material & Sub costs. Cutting those costs will drip that additional money to Real Revenue and make more money available for Profit, Owner's Pay, Tax and for Operating Expenses.

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I have 15 part-time employees who do pet sitting for me and are paid on a per-job basis. Are they considered sub-contractors?

Yes. Employees or contractors who are compensated per project are considered subcontractors. So, you would subtract the costs of those individuals from your Total Income to find your Real Revenue.

Profit, Owner's Pay & Tax Allocations

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Since the Profit, Owner's Pay and Tax accounts are all for the benefit of me, the owner of the business, can't they just be one account instead of three?

No. While the money allocated to these accounts do all benefit the owner(s), the use of the money is distinct. The Owner's Pay is for the owner's salary or regular recurring distribution. The Profit account is used as a quarterly bonus (and can also function as a rainy day fund, or used for a "Death to Debt" quarterly distribution.). The Tax account is used to pay the owner's taxes (and corporate taxes). So while the money does all benefit the owner, the accounts need to be kept separate so that you can instantly tell (by just looking at your bank balance) what money is allocated to what purpose.

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I take a salary from payroll, do I still need an Owner's Pay account?

Yes. You just transfer the money from Owner's Pay to the payroll account when pay time comes. The purpose is to always be able to instantly see what money the company is allocating to Owner's Pay (and the other accounts) when you look at your bank balances.

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I take my owner pay in distributions. Do I still need a Profit and separate Owner's Pay account, since all the money flows to me?

Yes, you still need both an Owner's Pay and Profit account. The Owner's Pay is distributed to you on the 10th and 25th and should a consistent amount should be withdrawn (acting like a payroll). Then on a quarterly basis the Profit is distributed, acting like a bonus (which it is).

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Why is the Tax allocation 15%? It seems very high.

The Tax account is intended to pay both corporate taxes and the personal taxes of the business owner(s). When the owner has periodic taxes due (quarterly or otherwise) the business "pays" for the owner's taxes. And since the money is being allocated to taxes on the 10th and 25th (or similar schedule) the taxes should be reserved well in advance by the business and negate the panic of "scrambling for money" when taxes are due.

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I am an owner in the business, and our payroll is such that my tax is already deducted from pay. Do I still need to reserve such a high percentage in the Tax account?

Yes. The reason you still need to reserve the percentage of money in your Tax account to cover both the corporate and personal tax is so the business can “reimburse” you for your tax payments that have been taken from your salary. While logically “it doesn’t make a difference” since you could just increase the Owner’s Pay allocation and reduce the Tax allocation, behaviorally it makes a big difference.

When tax is deducted for your pay, it feels like a loss of pay. This triggers the behavioral pain response of “loss aversion.” But if the business pays your tax requirements directly or reimburses you for the taxes that were “taken” from your pay, it reduces the negative association you feel with paying taxes. So, if you have taxes deducted from your pay, on a 10/25 rhythm (or monthly/quarterly/annually if your Profit First Professionals advises you to do so) use the monies allocated in the Tax account to reimburse you.

Additionally by allocating the actual tax percentages to the Tax account, your tax liabilities can’t be “hidden” from you as part of your salary and you will have a much better understanding of your real pay and real tax liabilities when you do bank balance accounting.

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I want to pay as few taxes as possible. Shouldn’t I run up expenses to cut taxes?

That is one of the most damaging myths of money management. Running up expenses to reduce taxes is the same as spending ten dollars to save three, it is very damaging to the business. The goal is to run the business as profitably as possible (that is the only way to achieve financial freedom), and you should work closely with a Profit First Professional to additionally reduce your tax liabilities as much as you can.

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I have an S Corp and as an owner, I am on payroll and have taxes deducted from it. Do I still need a tax account?

Yes. For a detailed explanation please refer to FAQ 14.

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I have to pay sales tax (I am a retailer) which account does that come from?

You would setup a separate checking account and call it Sales Tax (this is discussed in the advanced section of the Profit First book). The sales tax funds would be allocated from Total Income resulting in a Real Revenue amount. The Profit First allocations of Profit, Owner’s Pay, Tax and OpEx would come from the Real Revenue.

Remember that when you collect Sales Tax from customers that is NOT your money. You are serving as an agent for the government and collecting that money on their behalf.

Operating Expense Allocations

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I pay all my vendors on the same day on the month. If I do allocations to Operating Expenses (OpEx) on the 10th and 25th will it be problematic for paying vendors on time?

No, that will not pose a problem. Let's say you pay vendors on the 10th only. When the allocation goes into OpEx on the 25th it will just sit there. Then when the next allocation on the 10th goes into OpEx it will add to what is there. You then, on the 10th, pay your vendors from what you have in OpEx.

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Where do I pull the money from if I don't have enough money to pay expenses from my Operating Expense account?

This is the "come to Jesus" moment when you follow Profit First. The moment will come for every business where you don't have enough money in the Operating Expense account to pay your bills. The rule is this, you may NOT use other money. In fact this is the moment your business is yelling at you and shaking you saying that you CAN'T afford to continue to carry all these cost and you need to find a better way. Reduce your costs, and find a way to pay what you owe when the next allocation to OpEx comes in...but no matter what you must cut your costs.

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Why does the money need to be moved twice, first from INCOME to PROFIT at Bank 1, and then transferred to PROFIT at bank 2... if it is going to a second bank?

The logic of moving money twice... from INCOME to PROFIT (and TAX) at your existing bank, and then doing a second transfer to the second bank is that the transfer internal to the 1st bank is instantaneous. The money moves immediately, and when you instantly know what is was allocated for. The transfer of money to the second bank can take a day or two or sometimes longer. So the money "sits" at the first bank for a few days, and can becoming confusing or tempting if it is not moved immediately.

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Should Profit First be done retroactively?

No. The allocations start the day you implement Profit First, with your very next deposit. You don't do anything retroactive. So the money in your accounts currently just stay where they are (probably in one checking account). You setup Profit First with all new accounts at this same bank, but don't use the existing checking account with all the money currently pooled up in it as one of the Profit First accounts. Then you start doing Profit First allocations with the next deposit and follow the process. You handle the money that is pooled up in the prior account as you normally have been... until that money is fully drain (to \$0.00) over time. Then you can close the account or use it for another profit first account.

Expenses that are fully for the owner's benefit (leasing a car, club membership or something) would be paid out of the Owner's Pay account... since it is an owner benefit. But since it is paid by the company from that account, for tax purposes, it still acts like an expense.

Debt**25**

My business has debt. I can't be profitable until I pay off all my debt.

Wrong. In fact, the only way to pay off debt (which is simply past expenses that you haven't paid for yet) is to be profitable. You must currently make more than you are currently spending, so that you have current profits. Then you use those profits to pay off your debt (past expenses).

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I have multiple loans and forms of debt. How do I pay it all off?

Pay all the minimum fees out of your Operating Expenses. Then use any remaining money you have in Operating Expenses (after paying other bills) to pay off your smallest debt as fast as you can. No matter what keep doing the profit allocation of Profit First every 10th and 25th. I know this sounds crazy, since you have debt to pay... but you **MUST** build up that habit of always taking your profit first. Then when you do your quarterly profit distribution, take 95% to 99% of that distribution money and use it to crush one of your debts. The remainder (5% to 1%) is used for you to celebrate. This process has you constantly chipping away debt (from Operating Expenses) and then quarterly hitting that debt really hard. It is kinda like boxing... jab, jab, jab then a massive right hook.

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I have lots of debts including credit cards, personal loans, and banks loans. Some are very high interest rates. Which debts do I pay first?

While logically you want to pay off your highest interest rate loans first, Profit First is all about leveraging human behavior. One of the critical behaviors is "early successes." When we see early, even if it is small, progress in our management of money, we become more committed to the process. In regards to debt, Dave Ramsey (author of The Total Money Makeover) suggests a technique that is in perfect alignment with Profit First.

The process is simple. First sort all your debts from smallest amount due to largest. Then put all your financial effort in eradicating the smallest debt (in dollar amount) first, while maintaining the minimums due on all other debts. Then once the smallest debt is paid off, target the next smallest debt on your list. Wipe that out, and then hit the next. This will build a series of "early successes" and create a "snowball effect" as more and more money is freed up (as the small debts are paid off) to target the remaining debts.

Other Applications Of Profit First**28**

Can I use Profit First to identify a good business to buy?

Yes!!!! Do an Instant Assessment on them. It shows what needs to be "corrected" in the numbers. Less correction = Better buy.

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Can I implement the Profit First system before my business is profitable?

Always start right away. By implementing the system you will force profitability (not wait for it). Start at a low percentage... maybe 1%, but get started NOW!

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How do you adjust the Profit First allocation percentages for other currencies (outside the US)?

Profit First is a percentage based system, so it works irrespective of currency or dollar amounts. Just convert your currency to US currency to find your revenue range and the corresponding TAPs. Then follow the process as normal.

Since the TAPs are just targets. Every quarter you will need to adjust up and closer to your TAPs and find what is working for your business. Additionally you may discover that your tax allocation needs to be higher. If that is the case, adjust the allocations accordingly.

Perfecting the allocation percentages is secondary to just getting started. Over time you will find the perfect percentages for your business.

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My business is a brand new startup. When should I implement Profit First?

Immediately. In fact the sooner you start with Profit First the sooner you will master financial discipline and force your business to run efficiently. No matter how new or established your business is, you should not wait to implement Profit First.

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Does Profit First translate into personal financials?

Yes. While the full explanation would represent another book (hint. hint.), the premise is the same. Set up multiple bank accounts: **1. Income** (for deposits only); **2. Financial Freedom** (the same as a Profit account); **3. Fun** (similar to Owner's Pay); **4. Big Purchases** (savings for car, home, etc.); **5. Living Expenses** (similar to Operating Expenses); **6. Family Member 1 Expenses**; **7. Family Member 2 Expenses**, etc.

Money comes into the Income account and on the 10th and 25th the allocations happen. The Living Expenses is the account for ongoing household expenses. The Family Member Expenses accounts are the accounts for the family members with personal spending budgets (usually wife and husband), and these are linked to debit cards.

Hopefully that is enough to get you started. Never forget this system is flexible, you can change percentages to match your needs and you can set up additional accounts. The key is to always separate out your profit (in this case the Financial Freedom and Fun accounts) before anything goes to expenses.



Want to dive deeper into Profit First? Read the book!

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