

Digital Mastermind Group
September 17, 2013
Las Vegas

by
Greg Crabtree
Greg.crabtree@crbcpa.net
256-704-0620



www.crbcpa.com

FOREWORD BY **VERNE HARNISH**, CEO, GAZELLES, INC.,
AUTHOR, *MASTERING THE ROCKEFELLER HABITS*

**SIMPLE
NUMBERS,
STRAIGHT TALK,
BIG PROFITS!**
4 KEYS TO UNLOCK YOUR
BUSINESS POTENTIAL

GREG CRABTREE

WITH BEVERLY BLAIR HARZOG

Seeing Beyond Numbers



“Most people miss opportunity because it wears overalls and looks like work”

– Thomas Edison



Simple Numbers... Straight Talk... Big Profits *4 Keys to Unlock Your Business Potential*

- **Your data is lying! - Why how you deal with Owner's compensation is distorting your data**
- **Profit matters more than you think – How to set the right profit targets for your business**
- **Labor Productivity drives you profit engine – How do measure it and improve it**
- **4 Forces of cash flow – Get the priorities right to set your business on a solid foundation**



Why Owner Salaries Matter

- You get
 - a salary for what you do and
 - a return on what you own
- Why Your Net Income is lying!
- Be a More Demanding Employee
- Be a More Demanding Shareholder
- Can distort profits from start up to over \$60 million in revenue



Three examples

	Company 1	Company 2	Company 3
Revenue	\$1,000,000	\$1,000,000	\$1,000,000
Salaries	\$400,000	\$500,000	\$600,000
Operating Costs	\$350,000	\$350,000	\$350,000
Total Expenses	\$750,000	\$850,000	\$950,000
Pre-tax Net income	\$250,000	\$150,000	\$50,000
as % of Revenue	25.0%	15.0%	5.0%



Three examples - Continued

	Company 1	Company 2	Company 3
Revenue	\$1,000,000	\$1,000,000	\$1,000,000
Salaries	\$400,000	\$500,000	\$600,000
Operating Costs	\$350,000	\$350,000	\$350,000
Total Expenses	\$750,000	\$850,000	\$950,000
Pre-tax Net income	\$250,000	\$150,000	\$50,000
as % of Revenue	25.0%	15.0%	5.0%
Owner salaries included above	\$0	\$100,000	\$200,000
Dividends taken out	\$250,000	\$0	\$100,000
Market based wage	\$100,000	\$100,000	\$100,000
Revised actual net income	\$0	\$150,000	\$(50,000)
Business Net potential	\$150,000	\$150,000	\$150,000
Cash available to grow	\$0	\$150,000	\$(50,000)



Gregism

**When you have 2 or more owners
working in the business.....**

“Fair does not Mean Equal!”

**Example of how we solved the equal
problem with a 2 owner company**



Profit Terms – Watch your language!

Weak

- **EBITDA** - Earnings before: Interest, Taxes, Depreciation and Amortization – the most abused term in finance

Best

- **Pre-tax profits** – easier to define and more traceable to true cash flow

Weak

- **Revenue** – This is the vanity number

Better

- **Gross profit** – Revenue less direct costs (the true economic engine) – my definition excludes labor

Best

- **Contribution margin** – my definition is gross profit minus direct labor



Exhibit 2.1 - Gross Profit Examples

	Construction Company	Services Company
Revenue	<u>\$20,000,000</u>	<u>\$3,750,000</u>
Cost of Goods Sold:		
Materials	5,000,000	-
Subcontractors	<u>12,150,000</u>	<u>900,000</u>
Total Cost of Goods Sold	<u>17,150,000</u>	<u>900,000</u>
Gross Profit	2,850,000	2,850,000
Direct Labor	<u>1,000,000</u>	<u>1,000,000</u>
	Direct LER 2.85	2.85
Contribution Margin	<u>1,850,000</u>	<u>1,850,000</u>
Operating expenses:		
Facilities	150,000	150,000
Marketing	75,000	75,000
Salaries (management and admin)	750,000	750,000
Payroll taxes and benefits	100,000	100,000
Other operating expenses	<u>150,000</u>	<u>150,000</u>
Total operating expenses	<u>1,225,000</u>	<u>1,225,000</u>
	Management LER 2.46	2.46
Net operating Income	<u>625,000</u>	<u>625,000</u>
	Overall LER 1.63	1.63
Other expenses:		
Depreciation	75,000	75,000
Interest Expense	<u>25,000</u>	<u>25,000</u>
Total other expenses	<u>100,000</u>	<u>100,000</u>
Pre-tax Net Income	<u>\$525,000</u>	<u>\$525,000</u>
	as a % of Revenue 2.63%	14.00%
	as a % of Gross Profit 18.42%	18.42%

Exhibit 2.1 - Gross Profit Examples

		Construction Company	Services Company	
Business engine	Revenue	<u>\$20,000,000</u>	<u>\$3,750,000</u>	
	Cost of Goods Sold:			
	Materials	5,000,000	-	
	Subcontractors	<u>12,150,000</u>	<u>900,000</u>	
	Total Cost of Goods Sold	<u>17,150,000</u>	<u>900,000</u>	
	Gross Profit	2,850,000	2,850,000	
	Direct Labor	<u>1,000,000</u>	<u>1,000,000</u>	
	Direct LER	2.85	2.85	
	Contribution Margin	<u>1,850,000</u>	<u>1,850,000</u>	
Business chassis	Operating expenses:			
	Facilities	150,000	150,000	
	Marketing	75,000	75,000	
	Salaries (management and admin)	750,000	750,000	
	Payroll taxes and benefits	100,000	100,000	
	Other operating expenses	<u>150,000</u>	<u>150,000</u>	
	Total operating expenses	<u>1,225,000</u>	<u>1,225,000</u>	
		Management LER	<u>2.46</u>	<u>2.46</u>
	Net operating Income	<u>625,000</u>	<u>625,000</u>	
		Overall LER	<u>1.63</u>	<u>1.63</u>
	Other expenses:			
	Depreciation	75,000	75,000	
Interest Expense	<u>25,000</u>	<u>25,000</u>		
Total other expenses	<u>100,000</u>	<u>100,000</u>		
	Pre-tax Net Income	<u>\$525,000</u>	<u>\$525,000</u>	
	as a % of Revenue	2.63%	14.00%	
	as a % of Gross Profit	18.42%	18.42%	

Does your engine fit the frame it is trying to move?

Marketing Company example

4 Year History of Marketing firm
example



Breaking Even Isn't Good Enough Why 10% is the New Breakeven

Profitability Percentages (Pre-Tax):

5% - You're on Life Support

10% - When you're a *good* business

15% - When you're a *great* business

- **Anything over 15%, take it while you can!**

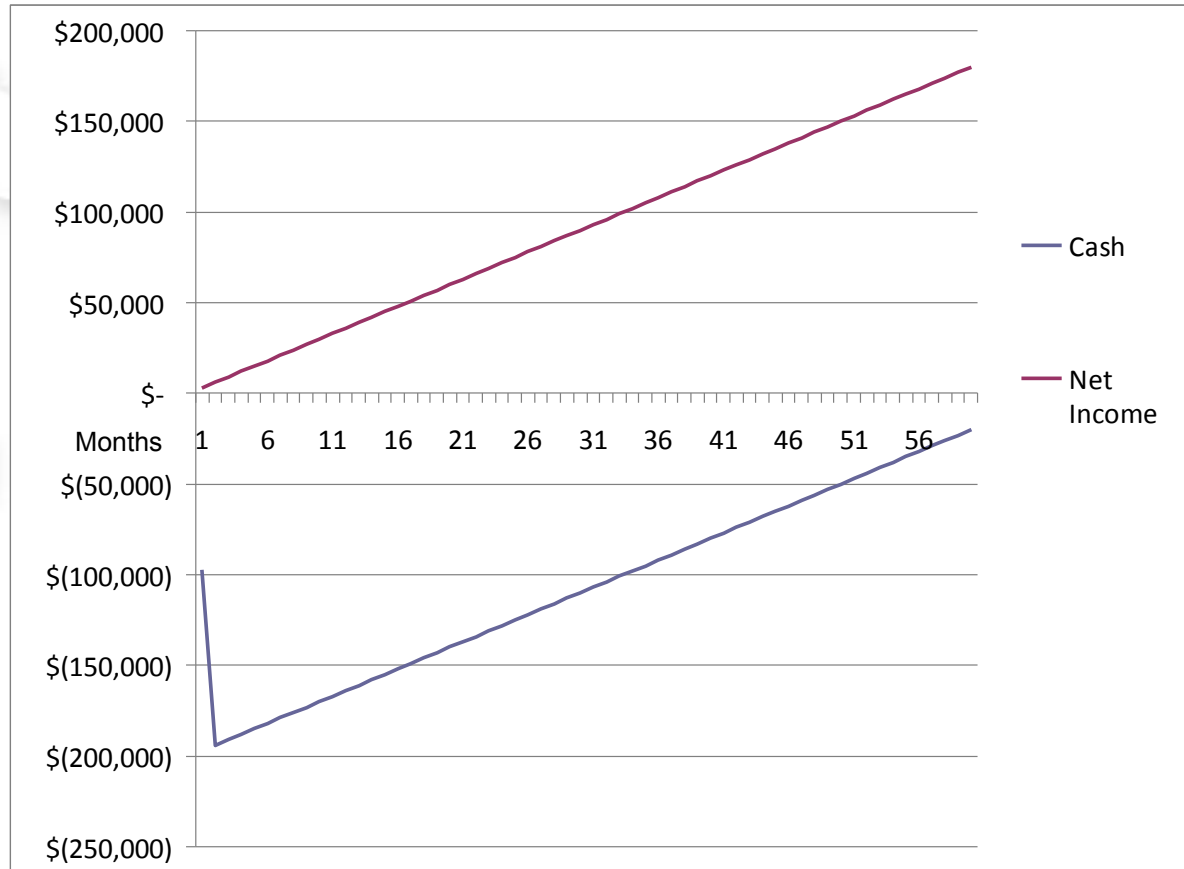


Cash Flow versus Profit

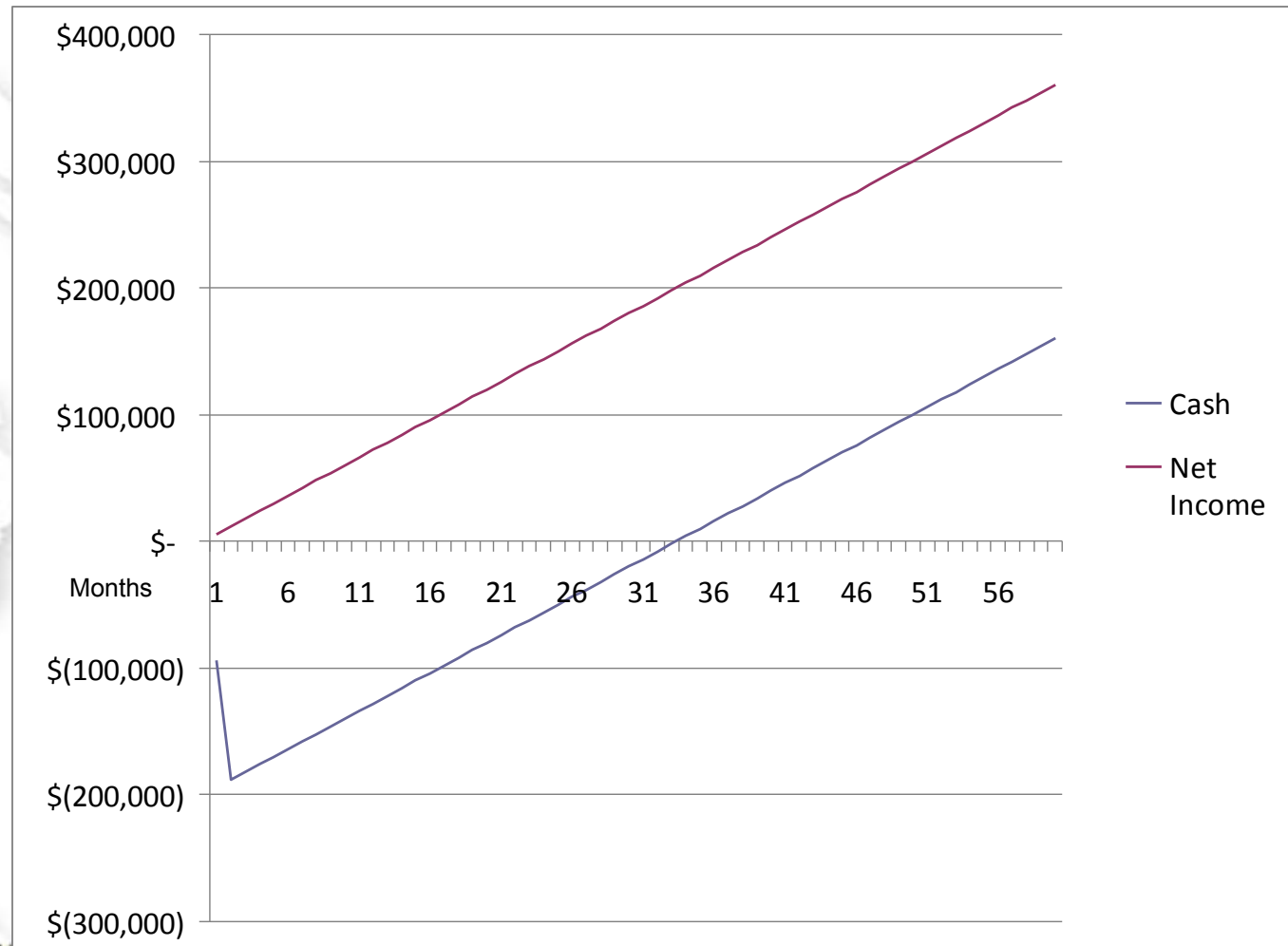
- **Examples at 5%/10% & 15%**
- **Revenue at \$100,000 per month**
- **Tax Rate 40%**
- **Assume service based business that bills at the end of the month and gets paid in an average of 45 days**



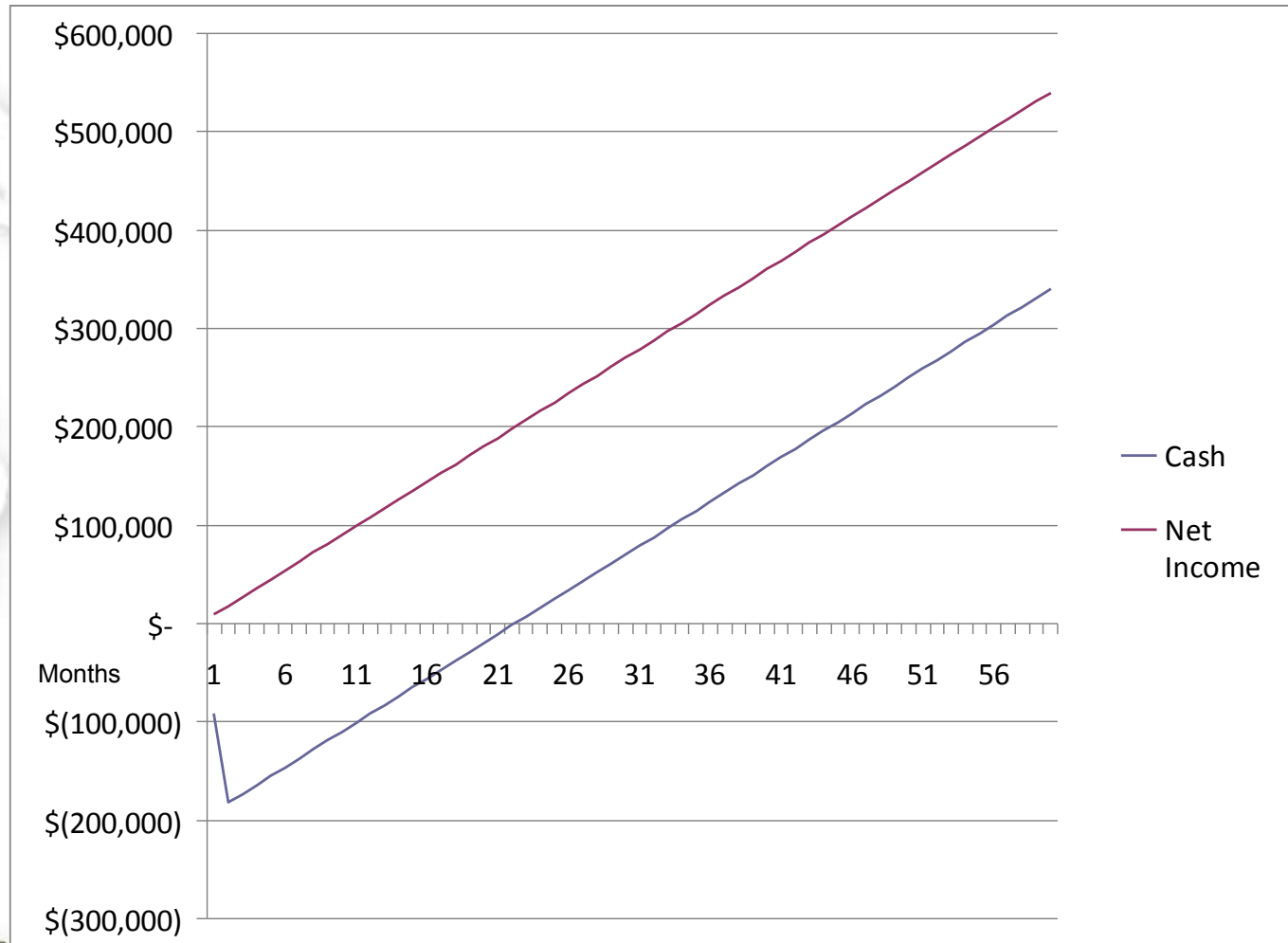
Cash Flow versus Profit 5%



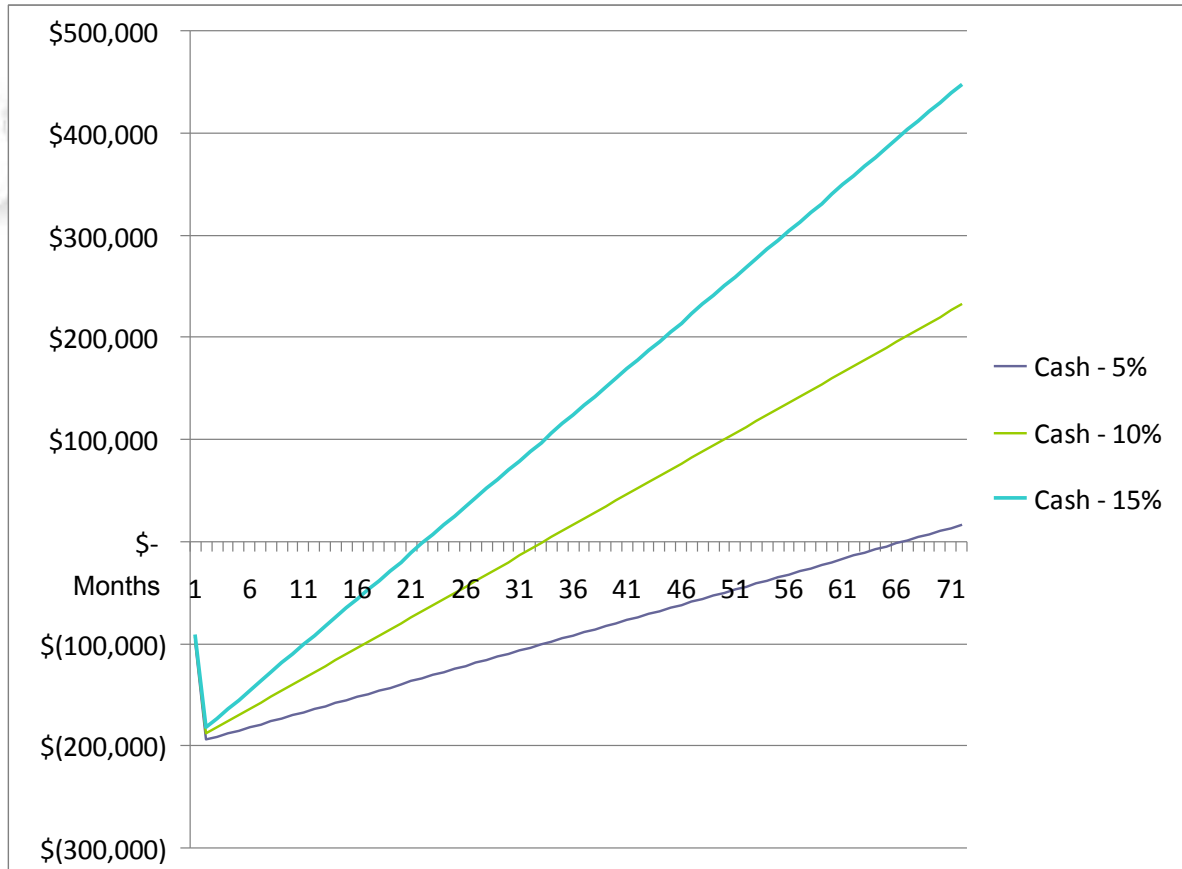
Cash Flow versus Profit 10%



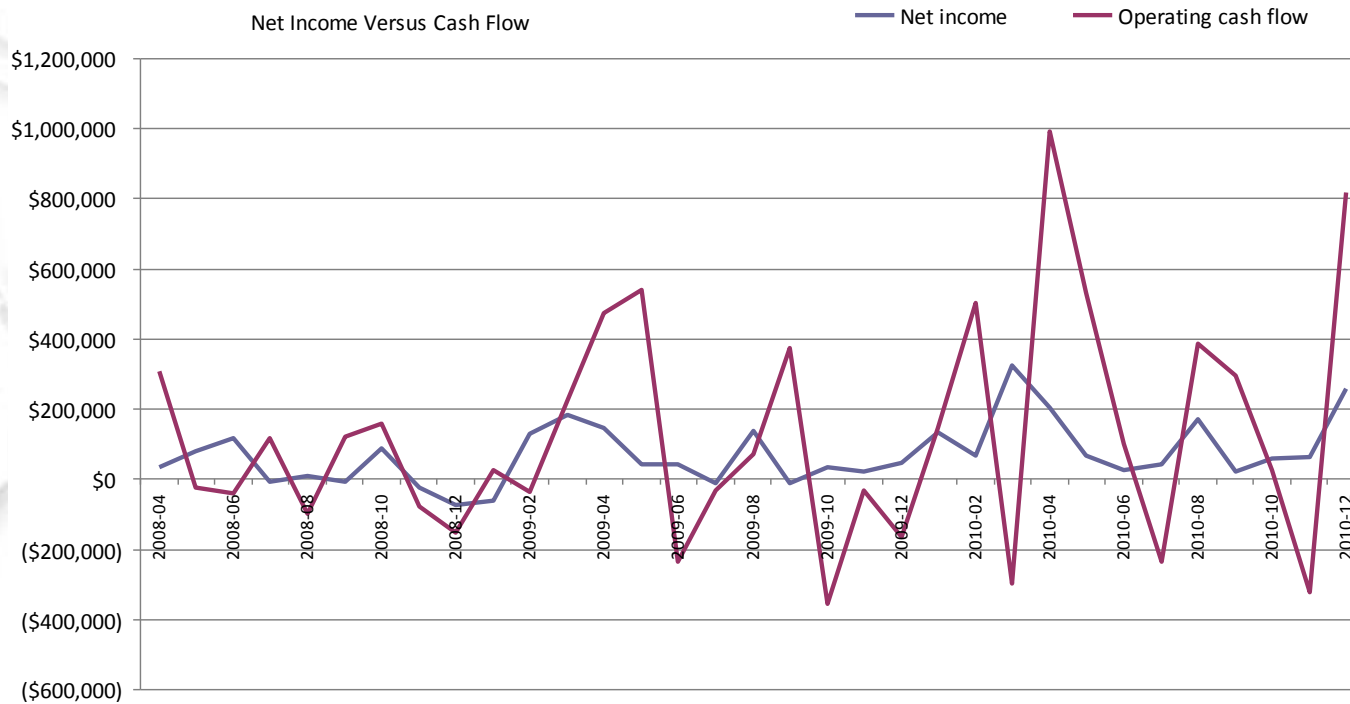
Cash Flow versus Profit 15%



Cash Flow versus Profit Recap



Ups and Downs of Operating Cash Flow



From Start-Up to \$5 Million

- **Eight Functional Areas (from Gazelles.com):**
 - 1. CEO**
 - 2. Sales**
 - 3. Marketing**
 - 4. Operations**
 - 5. Technology**
 - 6. Finance**
 - 7. Customer Service**
 - 8. Human Resources**

MythBuster

The vast majority of businesses that survive are profitable by the time they reach \$1 Million



\$1 Million to \$5 Million: How to be Successful on the Journey

- Are you receiving:
 - 1.) Market Based Wage
 - 2.) Return on Investment
- If your living off profits and salary of the business: ***Do Not Attempt to Expand***
- Get profitable, get out of debt and get your market wage before you start the journey



Labor Productivity is the Key to Profitability

- **Salary Cap concept**
- **Real life examples of change after introduction to the Salary Cap concept**
- **Million Dollar Makeover**



Plugging in Your Salary Cap Number

Revenue \$1,000,000

Salaries ????

Non Salary Costs ????

Total Expenses ????

Pre tax Profit (10%) \$ 100,000



Plugging in Your Salary Cap Number

Revenue

\$1,000,000

Salaries

????

Non Salary Costs

????

Total Expenses

\$ 900,000

Pre tax Profit (10%)

\$ 100,000



Plugging in Your Salary Cap Number

Revenue		\$1,000,000
Salaries	????	
Non Salary Costs	\$400,000	
Total Expenses		<u>\$ 900,000</u>
Pre tax Profit (10%)		<u>\$ 100,000</u>



Plugging in Your Salary Cap Number

Revenue		\$1,000,000
Salaries	\$500,000	
Non Salary Costs	<u>\$400,000</u>	
Total Expenses		<u>\$ 900,000</u>
Pre tax Profit (10%)		<u>\$ 100,000</u>



Getting to 15% Pre-Tax Profit

- Know your current capacity
- Being Profitable and Maintaining Market Share can be better than growth
- Remember, 10% is the new breakeven
- Use the “baffle” concept to grow to 15% in profit before you add more labor



	Original
Revenue	450,000.00
Direct Costs excluding labor	<u>130,000.00</u>
Gross Profit	320,000.00 71.1%
Direct Labor	<u>90,000.00</u>
Contribution Margin	<u>230,000.00</u>
Management/Admin Labor	75,000.00
Sales Labor	35,000.00
Other Operating Costs	<u>100,000.00</u>
Pre-tax Profit	<u><u>20,000.00</u></u>
Pre-tax Profit as % of Revenue	4.44%
CM as % of Revenue	51.11%
Other Operating Costs as % of Rev	22.22%
Labor Efficiency:	
Direct Labor (GP/DL)	\$3.56
Sales Labor (CM/SL)	\$6.57
Management Labor (CM/ML)	\$3.07

	Original	Step #1 10%
Revenue	450,000.00	492,195.19
Direct Costs excluding labor	<u>130,000.00</u>	<u>142,195.19</u>
Gross Profit	320,000.00 71.1%	350,000.00 71.1%
Direct Labor	<u>90,000.00</u>	<u>90,000.00</u>
Contribution Margin	<u>230,000.00</u>	<u>260,000.00</u>
Management/Admin Labor	75,000.00	75,000.00
Sales Labor	35,000.00	35,000.00
Other Operating Costs	<u>100,000.00</u>	<u>100,000.00</u>
Pre-tax Profit	<u>20,000.00</u>	<u>50,000.00</u>
Pre-tax Profit as % of Revenue	4.44%	10.16%
CM as % of Revenue	51.11%	52.82%
Other Operating Costs as % of Rev	22.22%	20.32%
Labor Efficiency:		
Direct Labor (GP/DL)	\$3.56	\$3.89
Sales Labor (CM/SL)	\$6.57	\$7.43
Management Labor (CM/ML)	\$3.07	\$3.47

	Original	Step #1 10%	Step #2 15%
Revenue	450,000.00	492,195.19	534,383.35
Direct Costs excluding labor	<u>130,000.00</u>	<u>142,195.19</u>	<u>154,383.35</u>
Gross Profit	320,000.00 71.1%	350,000.00 71.1%	380,000.00 71.1%
Direct Labor	<u>90,000.00</u>	<u>90,000.00</u>	<u>90,000.00</u>
Contribution Margin	<u>230,000.00</u>	<u>260,000.00</u>	<u>290,000.00</u>
Management/Admin Labor	75,000.00	75,000.00	75,000.00
Sales Labor	35,000.00	35,000.00	35,000.00
Other Operating Costs	<u>100,000.00</u>	<u>100,000.00</u>	<u>100,000.00</u>
Pre-tax Profit	<u>20,000.00</u>	<u>50,000.00</u>	<u>80,000.00</u>
Pre-tax Profit as % of Revenue	4.44%	10.16%	14.97%
CM as % of Revenue	51.11%	52.82%	54.27%
Other Operating Costs as % of Rev	22.22%	20.32%	18.71%
Labor Efficiency:			
Direct Labor (GP/DL)	\$3.56	\$3.89	\$4.22
Sales Labor (CM/SL)	\$6.57	\$7.43	\$8.29
Management Labor (CM/ML)	\$3.07	\$3.47	\$3.87

	Original	Step #1 10%	Step #2 15%	Step #3 back to 10%
Revenue	450,000.00	492,195.19	534,383.35	534,383.35
Direct Costs excluding labor	<u>130,000.00</u>	<u>142,195.19</u>	<u>154,383.35</u>	<u>154,383.35</u>
Gross Profit	320,000.00 71.1%	350,000.00 71.1%	380,000.00 71.1%	380,000.00 71.1%
Direct Labor	<u>90,000.00</u>	<u>90,000.00</u>	<u>90,000.00</u>	<u>98,333.33</u>
Contribution Margin	230,000.00	260,000.00	290,000.00	281,666.67
Management/Admin Labor	75,000.00	75,000.00	75,000.00	83,333.33
Sales Labor	35,000.00	35,000.00	35,000.00	43,333.33
Other Operating Costs	<u>100,000.00</u>	<u>100,000.00</u>	<u>100,000.00</u>	<u>101,666.67</u>
Pre-tax Profit	<u>20,000.00</u>	<u>50,000.00</u>	<u>80,000.00</u>	<u>53,333.33</u>
Pre-tax Profit as % of Revenue	4.44%	10.16%	14.97%	9.98%
CM as % of Revenue	51.11%	52.82%	54.27%	52.71%
Other Operating Costs as % of Rev	22.22%	20.32%	18.71%	19.03%
Labor Efficiency:				
Direct Labor (GP/DL)	\$3.56	\$3.89	\$4.22	\$3.86
Sales Labor (CM/SL)	\$6.57	\$7.43	\$8.29	\$6.50
Management Labor (CM/ML)	\$3.07	\$3.47	\$3.87	\$3.38

	Original	Step #1 10%	Step #2 15%	Step #3 back to 10%	Step #4 back to 15%
Revenue	450,000.00	492,195.19	534,383.35	534,383.35	587,821.68
Direct Costs excluding labor	<u>130,000.00</u>	<u>142,195.19</u>	<u>154,383.35</u>	<u>154,383.35</u>	<u>169,821.68</u>
Gross Profit	320,000.00 71.1%	350,000.00 71.1%	380,000.00 71.1%	380,000.00 71.1%	418,000.00 71.1%
Direct Labor	<u>90,000.00</u>	<u>90,000.00</u>	<u>90,000.00</u>	<u>98,333.33</u>	<u>98,333.33</u>
Contribution Margin	230,000.00	260,000.00	290,000.00	281,666.67	319,666.67
Management/Admin Labor	75,000.00	75,000.00	75,000.00	83,333.33	83,333.33
Sales Labor	35,000.00	35,000.00	35,000.00	43,333.33	43,333.33
Other Operating Costs	<u>100,000.00</u>	<u>100,000.00</u>	<u>100,000.00</u>	<u>101,666.67</u>	<u>105,000.00</u>
Pre-tax Profit	<u>20,000.00</u>	<u>50,000.00</u>	<u>80,000.00</u>	<u>53,333.33</u>	<u>88,000.00</u>
Pre-tax Profit as % of Revenue	4.44%	10.16%	14.97%	9.98%	14.97%
CM as % of Revenue	51.11%	52.82%	54.27%	52.71%	54.38%
Other Operating Costs as % of Rev	22.22%	20.32%	18.71%	19.03%	17.86%
Labor Efficiency:					
Direct Labor (GP/DL)	\$3.56	\$3.89	\$4.22	\$3.86	\$4.25
Sales Labor (CM/SL)	\$6.57	\$7.43	\$8.29	\$6.50	\$7.38
Management Labor (CM/ML)	\$3.07	\$3.47	\$3.87	\$3.38	\$3.84

Thinking model

	Actual	Change	Target
Revenue	6,234,494.04	1,122,567.98	7,357,062.02
Non Labor Direct costs	815,714.64		962,590.25
Gross Profit	5,418,779.40		6,394,471.77
<i>as % to Sales</i>	86.92%		86.92%
Direct Labor	1,980,924.25	356,863.52	2,337,787.77
Contribution Margin	3,437,855.15		4,056,684.00
<i>as % to Sales</i>	55.14%		55.14%
<i>Direct LER</i>	2.74		2.74
Operating Expenses:			
Facilities	370,655.12		370,655.12
Marketing	199,181.28		235,045.38
Management Labor	1,104,400.00	200,000.00	1,304,400.00
Payroll taxes & benefits	230,607.08		272,368.59
Other operating expenses	819,406.72		966,947.12
Total Operating Expenses	2,724,250.20		3,149,416.22
<i>as % to Sales</i>	43.70%		42.81%
<i>Management LER</i>	3.11		3.11
Net Operating Income	713,604.95		907,267.78
<i>as % to Sales</i>	11.45%		12.33%
Marketing as % of Revenue	3.19%		3.19%
PR Taxes & Benefits as % of All Labor	20.88%		20.88%
Other Operating Expenses as % of Revenue	13.14%		13.14%

Where Did the Cash Go?

Beginning Cash	\$100,000	
Net income	<u>\$125,000</u>	
Cash available:		\$225,000
?????????	??????	
?????????	??????	
?????????	??????	
?????????	??????	
	<hr/>	
Total cash adjustments		<hr/> \$200,000
Cash at end of year		<hr/> \$25,000



Where Did the Cash Go?

Beginning Cash	\$100,000	
Net income	<u>\$125,000</u>	
Cash available:		\$225,000
Taxes paid (40% of Net Income)	\$50,000	
??????????	??????	
??????????	??????	
??????????	??????	
	<hr/>	
Total cash adjustments		<hr/> \$200,000
Cash at end of year		<hr/> \$ 25,000



Where Did the Cash Go?

Beginning Cash	\$100,000	
Net income	<u>\$125,000</u>	
Cash available:		\$225,000
Taxes paid	\$50,000	
Principle Payments	\$50,000	
??????????	??????	
??????????	<u>??????</u>	
Total cash adjustments		<u>\$200,000</u>
Cash at end of year		<u>\$25,000</u>



Where Did the Cash Go?

Beginning Cash	\$100,000	
Net income	<u>\$125,000</u>	
Cash available:		\$225,000
Taxes paid	\$50,000	
Principle Payments	\$50,000	
Vehicle Purchase	\$50,000	
?????????	<u>??????</u>	
Total cash adjustments		<u>\$200,000</u>
Cash at end of year		<u>\$ 25,000</u>



Where Did the Cash Go?

Beginning Cash	\$100,000	
Net income	<u>\$125,000</u>	
Cash available:		\$225,000
Taxes paid	\$50,000	
Principle Payments	\$50,000	
Vehicle Purchase	\$50,000	
Distribution – Down Payment on Condo	<u>\$50,000</u>	
Total cash adjustments		<u>\$200,000</u>
Cash at end of year		<u>\$ 25,000</u>



Cash Flow Revealed – How It Should Be

Beginning Cash	\$100,000	
Net income	\$125,000	
Cash available:		\$225,000
Taxes paid	\$50,000	
Principal payments	\$50,000	
	<hr/>	
Total cash adjustments		\$100,000
		<hr/>
Cash available to meet Core Capital Target		\$125,000
Core Capital Target (2 x \$50,000)		(\$100,000)
Cash available for discretionary spend		\$ 25,000
		<hr/>



4 Forces of Cash Flow

Prioritized In Order:

- Taxes
- Repay debt
- Build Working Capital (Core Capital Target)
- Dividends (Distributions)



#1 Force of Cash Flow

Taxes

- Before you spend, put aside \$\$ for Taxes, avoid the tax day “surprise”
- Cash versus Accrual
- Timing is Key



#2 Force of Cash Flow

Debt

- **Line of Credit:**

Should be reduced to \$0 for 30 consecutive days in a 12 month period

No “Evergreen” Loans

- **Long-Term Debt:**

Repayment of Debt only with after tax profits



#3 Force of Cash Flow

Working Capital a.k.a Core Capital

- **Core Capital Defined**
 - 2 months operating expenses in cash
 - After
 - All line of credit is paid off
 - Trade payables are current
 - Estimated taxes are current or set aside



#4 Force of Cash Flow

Distributions of Profits

- Safely Removing Cash in the form of dividends when it will not hurt the stability or growth of the business
- Know the difference between
 - “tax” distributions
 - “profit” distributions
 - *May or may not apply to non-US companies*

