Chapter 3

In Chapter Three, we're going to be talking about a key document called a Profit and Loss Statement. I'm sure some of you listening to this tape are even aware of what a Profit and Loss Statement is, and don't let it mystify you. It's one of two basic documents we need when we're getting involved in business either analyzing it or running the business, and one document is a Profit and Loss Statement which is it making a profit? Is it showing a loss? And, the other document is a document in the next section which has to do with Balance Sheets or the assets and liabilities.

In this section, we're going to start going through the area of a Profit and or Loss Statement, and if you want an example of this what I'd like you to do is just open your book and turn to page 3-7. Pull 3-7 from your book, and close the rings, and then turn back to the first section which is page 3-1, not the first section but the first page in this section, 3-1.

First of all, we have this business it's called "The Store", and you probably notice going through the program that we use different type of businesses and we go through. We're talking about manufacturing. We're talking about distributorships. We're talking about a service business here, and the reason why we do that is you're going to find as you get involved in business that all business are basically the same and although you may have this fantasy in the beginning about them being different, you're going to find there's very many similarities especially in the area of the key documents like the Profit and Loss Statement. As you go through this one or other parts of this program, you'll go through a manufacturing company, you'll see the key areas on a Profit and Loss Statement that do vary.

What I'd like to do now is take The Store here, and again, this happens to be a real business. No, this is not a business that I own, and the reason I'm not using this example a business I have owned or worked on because I needed a business that had fraud involved because as I'm going to be going through this I'm going to show you some of the tax problems you'll have from a standpoint of what the former owner is doing, and also where people are playing games and Mickey Mousing.

Again, I'm not doing it from a standpoint of teaching Mickey Mouse, although you could do this with this information, but what I'm trying to do is show you what you're going to find when you're analyzing a business you were to list or to buy it.

So, just set that on the store, and then by looking at 3-1, let's start going through the different information and see what we have on this Profit and Loss. First of all, we're talking about two different methods of accounting. We're talking about the cash method and we're talking about the accrual method. What we're really talking about is how do we handle it from a tax standpoint, and the key thing is going to be very disappointing as you get involved with businesses if you're not already, is you're going to find the average Profit and Loss statement never does tell what the business is doing.

All we basically have on a Profit and Loss statement is a profit or loss that was set up to reflect the lowest possible net for tax purposes, and I've been in this business for a long-time as I tell many of you. I still have that place on my wall for the first honest Profit and Loss Statement, and I still haven't seen it. I'm sure it exists, but I haven't seen it. The main reason being of course, people do cheat on their Profit and Loss statements, but the other thing is it is set up to reflect the tax line as opposed to representing to somebody what the business is making which means we've destroyed the past few years the profit and loss concept.

When we start talking about cash basis of accounting, what we're saying is the owner of a business is able to write-off their expenses as they pay them. In other words, you're not allowed to write them off as you incur them, as they happen. You're only allowed to write off your expenses as they are paid. So, what we have here on cash basis Profit and Loss, if you're looking at 3-1, we have $10,000 income in January 198x, and at the same time during January, we paid $8,000 in expenses. These are the bills paid. So, on a cash basis method we would show a $2,000 profit which would be what? Basically taxable at this point.

Now, this is a rip-off because bills paid in January are usually the December and November unpaid bills rather than expenses incurred in January, and who are we ripping off? We're ripping off ourselves as business owner because we then assume we had a $2,000 profit, and we didn't because what you have is you have the income in January minus the bills paid. That is not a Profit and Loss statement. That's really a cash statement because what happens as I said is you took in $10,000, you paid out $8,000 and you have $2,000 left. That does not mean you made a profit because what you're going to find probably as an example in January you'll take in $50. You won't pay any bills. What do you do? You show a profit.

You're really not showing a profit. What you're really doing is showing that if you take the money in, subtract the money that you spent out, you have 'X' number of dollars left in your hands which is more a relationship in how the cash is flowing in the business, and what you're going to have to find – you have to take on a Profit and Loss statement – you have to take the income or sales for the month, and subtract the expenses for that month, not for the bills paid. You have to subtract the expenses. If not, it is not going to reflect what the business really makes.

What I want to tell you as I tell everybody else in the United States, most of the business owners we run into that are on the cash basis are doing it wrong. Most of the business owners that we run into that are on a cash basis and doing it wrong are still very successful. They're make $10, $20, $50, $100, $200,000 a year, and they're doing it wrong. Again, I don't want to encourage you to do it wrong, but even if you're doing it wrong you're going to find because the average business owner doesn't know what he or she is doing, you're going to find that your competition is not as strong as you think it is. If you end up doing it wrong, you're going to find you're probably still going to succeed.

What we're trying to encourage you to do in this program is at least do a few of these things the way that we suggest, and if you do that, and if you're competing against people that do none of them right, you're going to find that both of you will probably stay in business, but you'll end up making more profit. You'll then be able to weather the recessions, the depressions. Why? Because of who you're competing with. You're competing with business owners that basically don't know what they're doing. Most of them don't have the tools, and the ones that do have the tools aren't using them.

Now, the other method here as we said the other method of cheating, we're going to talk about that in a little while, but before I do that let's mention the other method of accounting because what we're talking about is the accrual method. In the accrual method, basically what happens is we have an owner of a business and what they do then is they accrue expenses. Each month they not only are able to write-off or expense the bills they had, but they can accrue. What you end up with an accrual method, you end up with a more accurate Profit and Loss statement. We'll get into that later.

We talk about other methods of cheating in this area what we're really talking about is what happens when you're going to buy a business. You go up to this business owner, and the business reflects $50,000 net profits. You say, "Oh boy, that's wonderful." But, here's what happened. Let's set the scene. This is now January in our example here, February, and as you go back last year to last October and if you're in the sellers office you're going to find the seller saying, "Hey, this year we're only going to show a profit of nothing. We're going to show no profit. We're going to show no loss. I'd like to sell this business." And what you're going to find is he'll then sit down and talk to the suppliers and vendors and say, "Look, I'm paying my bills on time. Would you mind if I pay what I normally pay in November and December and move it maybe to January of next year?"

What happens is then this business that shows no profit, by them taking $50,000 of expenses from the prior year and say moving it to this year expense-wise, what you're going to find is if they move $50,000 of expenses on a business that showed no profit, how much profit will it show? That's right, $50,000. Did it really make $50,000? No. Could they make it show $150,000? Yes. They can make it show any number you want, and is it really making it? No. What's happened? You the buyer or the person listing the business has just been ripped-off. Do they do it quite often? Unfortunately, yes. Owners are not stupid.

The next thing is the inventory and what we're saying here is sometimes they take inventory annually, sometimes more often, sometimes it's estimated. The thing that's key here – the largest expense item in many businesses or most businesses is subject to the least control. What areas do they control least usually? Labor and the other thing is the cost of sales – what does it cost to operate, what is the inventory.

Let's take the example here that we have on the inventory and see what we have. First of all, the beginning inventory is what? $50,000. We're on 3-7 now under cost of sales. The next item down below under purchases is $200,000, and then we have an ending inventory of $50,000. What does this say basically? Well, the way you arrive at a thing called cost of sales is you take the beginning inventory – whatever the number happens to be – in other words, how much stock did we start with. You then add in the amount you purchased during that period either during the month or during the year, and then you subtract the ending inventory. If you do this and you do it properly, you'll end up with what your cost of sales were.

And, what does cost of sales mean? Well, basically in this business it is a women's clothing store, it will mean during the year – looking at 3-7 – the cost of sales were $200,000 which means we bought $200,000 worth of dresses and we resold them for what figure? $500,000. So, the cost of sales was across the bar merchandise or a garment, and this is what happens in a retail business. If you're in a service business, you're not going to have cost of sales. Why? Because you don't have a product, all you have is the services of people.

In the other example we had in the area of pricing, we used M Manufacturing, and with M Manufacturing under cost of sales in addition to having material, what we really have in manufacturing company is what if you will recall? You have material which comes in which is raw material, you add labor to it, mark it up and sell it which happens in manufacturing.

In a retail business, we don't have that. You have the material coming in. We add nothing to it. We just resell it. And how we make our profit? We mark it up – add X number of dollars to it as we resell it to give your sales of profit.

Now, in this example right here, we're going to have you moving about a bit. We'll come back to page 3-1, but while we're doing this, let's turn a couple of pages. Let's turn to 3-5. You should have 3-5 and 3-7 in front of you now, and what I want to do is talk about the inventory.

Now, first of all in this example right here on 3-5, we had beginning inventory of $50,000. We have purchases of $200, and then we subtract the ending inventory to get cost of sales. That's great, but did you notice that the beginning and ending inventory or both the same? What does it mean when the beginning and ending are both the same? Well, what it normally means is they didn't take the inventory. In fact, you'll see many companies that takes the inventory and it's $50,000.02 and you'll find that it's run that 50 times in a row. You're going to find they've estimated the inventory or basically what they did is they didn't even take it.

Now, how accurate is this? Some people are going to tell you this averages out and that's a flat out lie, or it's a statement made by somebody that doesn't know what they're talking about. The beginning inventory is $50,000. if you then add back in the purchases down below which is about half way down on 3-5, of $200,000, you'll notice in this example the second part which is the real world, we have an ending inventory of zero. Now, I've exaggerated this example a little, but let's suppose this had happened in this business that we have here. Well, instead of having cost of sales of $200,000, what are our cost of sales? $250,000. If you then take this back to the example that you have on 3-7, what would happen in the real world? This business is showing an inventory cost of $200,000. What is the true inventory cost? It's $250,000, and if you build the real numbers back into example of 3-7 instead of having a profit of $50,000, what is your profit? Zero.

I don't know exactly how to approach this now, but I have to tell you this next thing. even though we're talking about tax fraud, we find it comes up quite often. What you're going to find is owners of businesses when they're making out their tax statements, will take their tax statements and not want to pay a tax, and how do they avoid paying a tax? By Mickey Mousing the cost of sales. As an example, let's say 3-7. You own a business. You show a profit of $50,000 as you get down to end of the year, you decide you don't want to make a profit for tax purposes. Well, it's very simple. You could pay bills ahead of time which is legitimate and what you'd find is you'd end up not showing a profit. But on the other hand, the other way to do it is do a thing called writing-down which is in some cases legitimate, but we run into a lot of business owners that in the area of cost of sales will take the cost of sales figure and adjust it.

In this example right here, if your true cost of sales did happen come to $200,000, and you wanted to Mickey Mouse it, you could just make it on your statement $250,000, and when you do that you wipe out your tax.

Now, as you start looking at this, I want to warn you about something you're going to run into. You're going to run into businesses as you go out to look at them or to list them, and you're going to find that they're showing $50,000 inventory on the books.

When you walk into their warehouse, it looks like they have a million. Well, you're correct. They do have a million. And, what they do then is to play games, and they have all this excess inventory, and if you want to figure out how much they've ripped-off your government for or our government, it's the difference between the inventory that they show on their books and what they really have there, and this is Mickey Mouse.

This is tax fraud and what I'm trying to warn each and every one of you is if the seller of the business tells you that he or she wants to then run that inventory back through the business after you buy it, tell t hem to go somewhere because what they have done now is they have ripped off the federal government. I'm sure they've ripped off the state government. They probably have cheated their employees, but for you they've got a deal.

What we do is we give these people a hug and we tell them we're not interested. If you get involved in these businesses whether you're working as a buyer or whether you're working as a broker, you're going to get yourself in trouble. If you do, don't come back to me because Hamel warned you. You're working with a person that is now guilty of felony fraud, and what I suggest you do is stay away from them. You do not need that Mickey Mouse business. There's plenty of them around that are not playing games. But, if you do it – I warned you. I've seen many, many people in the past get in trouble. Don't do it. You don't need that business. Also, what kind of transaction are you going to have with somebody who does this because you know if they're doing it in one area, the next thing they're going to do is rip off you either the buyer or the agent and you end up getting in trouble. So, my word is don't do it.

Let's go back now to page 3-1 and talk about a thing called common ownership under number three, and it says, "Does this Profit and Loss Statement reflect the income expenses of this business only?" And, what we run into sometimes, the owner will own two or three businesses, and what they'll end up doing is they'll run expenses from one business to another.

A few years ago, we had an owner of a business that owned two different companies. One company showed a large profit. The other one showed a large loss. Why did one company show a large profit? Because the owner was running all his labor against the loss company which means the other company that would've probably been breaking even, showed a big profit. Why? They didn't have a labor figure. Was it included between the two companies? Yes.

What I'm saying is you better go slowly. You better dot your I's and cross your T's and even though we're telling you how to verify and check things as you're going analyzing businesses, you have to realize when you get down to the end, you're going to have to have a CPA go through the books everytime and verify and reverify everything. For those of you who don't bring the professionals in later to check the books and verify them and make sure you haven't been ripped off, you will get ripped off.

The amount of money that you spend for the professionals in the business whether you're buying it or putting up a business transaction is worth it. Every cent is worth it. Why? A business transaction is complex. I don't care how smart you are or how bright you are, you're going to find that you are not going to be able to keep up and you're not going to be able to be that brilliant in all the areas. So, bring in other people. It's worth it. You're not wasting money. Believe me.

The next area, owner benefits, perks, volcanoes. When we start talking about perks we're talking about perk and benefits and it says, "See detail on the Profit and Loss adjustment sheet", and we're going to get into owner benefits a little later, and as we do you're going to start to see what the perks are, the benefits. Again, a perk is something that basically we're talking about in a large company. The president of a large company has a company car, a special insurance program – things like that. And, you're going to see in large corporations although they do have a lot of these benefits, it's nothing compared to what the small business owner takes as benefits in their business.

As we go through this a little later, you're going to find some of them are legitimate and other ones aren't. Again, we're not going to be trying to teach you the Mickey Mouse ones, but the thing is you go out to get involved in business either buying or listing them, you have to understand what the Mickey Mouse is. Why? Number one, if you appear to be not knowledgeable in this area, the seller is not going to be impressed with you and be fearful of working with you, and on the other hand, you have to be aware of it because you're going to have to try to determine in a little while how much profit this business is really making. We'll get to that in a few minutes.

Standard accounting practice is inadequate. The average Profit and Loss statement is set up and used over the year to lower the tax bite and not to run the business. The net profit that a business reflects is not a true measure of what the business is really producing, and I've said that a couple of times in this section, and what we're saying is the bottom line net does not really reflect what the business makes, it reflects what? It reflects the bottom line figure for tax purposes, and you can't use this to run a business and you also can't use this to buy or sell a business. Why? Because it doesn't reflect what this should be based on. We'll mention this again because it's very important.

What I'd like to do now as you've considered these different things, what I'd like you to do now is pull out 3-9 or just turn to 3-9, and on one side you'll have 3-7 and the other side you'll have 3-9. We're now in this section going to go through the buyer's Profit and Loss adjustment sheet.

Now, you're probably wondering in this program why we just didn't sit down and show you all the different accounting functions and how to put together books, and that's not our purpose because the purpose in this program is to show you how to analyze a business, and you're going to find in most businesses you'll have a Profit and Loss statement. You'll also have some sort of bookkeeping system, and all we're doing is showing you how to check those things out.

As you check those things out, you're going to say, "Is this all that you check?" Well, this is all we're checking at this level because this is where you're going to find most of the fraud, most of the misrepresentation, and most of the things that are going to make it difficult or impossible for you to make a decision or to analyze where you're going either as an agent for one of the two parties or as a buyer of a business.

As we think about the buyer's Profit and Loss adjustment sheet here on 3-9, you're going to find that what we're going to do now is build back into the company different perks and benefits because we're going to try to find out what it's really making because right now it shows $50,000 and it's paying tax on $50,000. And, over the years what we have found because we have had the opportunity in our program to own a lot of companies, we've also had the opportunity to analyze a lot of companies for our own purchase and also analyze companies for the tens of thousands of graduates of our programs. So, we've analyzed hundreds of thousands of businesses over the years. Our average that we have found, and again it's not scientific but based on our studies over the years, we have found when a business is paying tax on $50,000, we usually find another $100-$150,000 of perks and benefits that the owner of the business is taking.

Now, what percentage are legitimate? We have tried to keep track of that. I'm sure the IRS has. What we've looked at it is from a total standpoint. In other words, this money is really profit of the business. Some of it is taken as tax benefit. The other they're cheating on. Is there cheating going on? Yes. I'm not going to hide it. If you want to go talk to the Internal Revenue, Internal Revenue's going to tell you that's why they have so many agents because the games people are playing.

One thing I'd like to mention at this time – for those of you that are going to go out and consider playing games on taxes, I've been working in this area for a long time not in taxes but in the buying and selling of businesses. It always makes me laugh because the average person I've run into is Mickey Mousing on their taxes and as we go through it, and again we're not tax experts, we find that they have missed write-offs that are equal to or greater, and what they do is they spend many, many hours every year trying to cheat on their taxes, and we keep trying to tell them why don't you get a good CPA or a good tax advisor, spend the money. Not only will you get many times the money back that you spent on that tax advisor, but the amount of write-off you get legitimately is more than you're cheating on now which means everything you're doing is stupid. It's counterproductive. It's negative, but again, do it your way eventually you'll come around to my thinking.

We keep trying to tell you you can make more money in business honestly than you can dishonestly, and what you should do is quit wasting all your energy on all these other Mickey Mouse schemes and scams. As we start to think about the buyer's Profit and Loss adjustment sheet, we're going to start at the top with $50,000 net. We're going to take the $50,000 and whatever the figure is off the bottom of the Profit and Loss statement, and we're going to add and subtract things as we go along to see what number we end up with. So, we're going to have positive adjustment. We're going to have negative adjustments. Then, we're going to find out how much profit's available, truly available in this business.

One of the first things you're going to run into is the owner. The owner's pulling out so much, and when you get involved in analyzing business as an agent or if you're going to do this as a buyer, you have to get it down to the point where the thing makes sense.

For those of you who are selling your business, you have to do the same thing because if you're business only shows $50,000 net and if it's truly making $150 or $200,000 and you don't present this in the right manner to the other party, you're not getting the right price or value for your company. You're selling it for a lot less because you're business does make a lot more than the Profit and Loss shows.

Now, as we start to go through this, the first thing we have is the owner, and if we look at 3-7, if we go down, look at under salary of officers, it says $80,000, and you're going to find the owner then is pulling out $80,000 from this business. The owner's paying himself $80,000. So, under owner we put $80,000.

Now, let me explain what we're doing right here. First of all when you get involved in businesses like sole proprietorships which we have here, you're going to find in this business that what we have is an owner running his or her own business. In this example right here, this business shows $50,000 bottom line net, but that's after the owner has pulled out how much for themselves? $80,000. As you go down the street and pull out the same size business you're going to find another business down the street showing $50,000 net after they've paid themselves $20,000.

On the other hand, you're going to find an owner on the other end who's paying themselves $150,000 a year for a salary and still shows $50,000, and as you analyze this you're going to find that one of the owners is pulling out $20,000 plus the $50,000 net shows total what in those two categories? $70,000. The one in this example right here is pulling out $80,000 plus $50,000. That's $130,000. And, if you look at another type business we mentioned where the owner's pulling out $100,000 plus the 80, that's $180,000.

Now, what I'm going to try to show you here now is you have to compare apples and apples. What you have to do is you have to sit down and try to figure out how much the owner's making, A, and you push that back in and you push back in the $80,000. We're then later going to back out what a manager's salary is. Now, why do we back out the manager's salary? We would like to get every business for analysis purposes down to the point where what we're looking at is what is the bottom line net after we push back in all the owner's perks and benefits legitimate and not legitimate, and then subtract out what a manager's salary is. This way you can compare apples and apples. It is a clean business, free of what the owner does, and it has a manager built in, whether the manager is there or not doesn't make any difference. If you don't do it that way, you're never going to be able to figure out whether one business is better or not as good as the other business. So, let's bring it back to one basic level. It will also help you find out what they're really making.

Now, this owner is pulling out $80,000. You say, "Well, is that a standard for a business?" There is no standard. If you don't believe it, talk to Internal Revenue Service, and you're going to find certain businesses that are very small and the person is basically work at the department level, running the department, that person is paying themselves $150,000-$200-$300,000 a year. Is that excessive? I'm not in a position to judge. All I'm saying is this is why IRS has so many auditors because of problems like this.

On the other hand, you're going to find a number of owners that don't pay themselves anything or pay themselves something less than minimum wage. Is that fair or legitimate? No it isn't. And, what we're trying to do is get it back to a legitimate level so we can analyze these businesses, put them in the proper order so we can find out where we're going.

So, what we do is we push back in the $80,000 and where it says "Owner" we add back in the $80,000. Now, let's go down a couple of lines. We'll go back to talk about the spouse, but if you look under the area where we say deductions for net profit it says $42,000. So, what we're doing is we're pushing back in or adding back in the $80,000 the owner did take out last year. We're now going to subtract out what it would cost to replace the owner or the manager. Now, if the manager's already there you don't have a problem, but let's say right now we have to add back in a manager. How do we find out what the figure is?

Now, we're not going to use government averages because that's what they are, they're averages. You're going to find they're too far off to analyze a business. So, what we normally do is we'll pick three or four business owners in the community, call them, and find out what the going rate is for that type business. Yes, we're talking about competitors. Don't tell me you can't get the information. You can.

What you do basically is you take the average. You may find one was $38,000 something, another one was $42,000, and the other one was $44,000. As you take the average of these three or four that you're looking at, you find the average including payroll taxes and other benefits came to $42,000 which is great. It's going to cost you $42,000.

Now, for those of you agents, attorneys, CPAs that are representing clients, you just don't call people and change the numbers. What you have to do as you call these different people, I would suggest that you get their name, you document the time you called them, and make up a letter that's like dictating letter to your file. The only reason we're doing that is to document that we made the call so that if something goes wrong and we have to go to court, we can tell the judge we at least did it semi-scientifically as opposed to just plucking it out of the air.

If you do it this way, you're going to have a pretty good number. You're going to have a number that's pretty accurate.

Let's go back up and talk about the spouse now because the spouse also gets involved, and again, a lot of you think of a wife, but we also know that business owner's some happen to women, and their husbands are involved. It might be a boyfriend or girlfriend, but again another member of the family or another friend.

Now, what we have quite often in business you'll have the main party running the business and paying themselves very well, and then when you get down to the second level, a spouse, you find they're usually not paid or paid very little. Now, a lot of times, they're keeping the books or doing something along that line. They're not being paid. When you then as a buyer come in to take over this business, you may have to replace the spouse with somebody making 25 or 30,000 a year, and when you do that, and you're buying a business making 25 or $30,000, you've just wiped out the profit, and you're back at zero. So, analyze this and find out where you really are. Are you going to have to replace somebody and what is it going to cost?

In some cases you may even find the spouse is making more than it's going to cost to replace them. But what you have to do is find out where you are and do it. Does this come up very often? Well, if you're new in the field, and you're about to go after you listen to this tape program and do it, within one week of doing this full time you're going to find that the spouse probably comes up almost every other time. It comes up quite often.

The next area that we have is a thing called relatives, and you're going to find businesses with relatives working in there also, and the relatives are either working for a lot more or a lot less. In all the years that I've been doing this, I don't remember one where they're working for exactly what they should've been. Let me give you an example I used to use in class a long time ago, and the reason we used to use it is the fact to display what you're talking about.

We analyze this business that was making about $30-$40,000 in profit, and as I analyzed it, we noticed that the total payroll was only $8,000. With a total payroll of

$8,000, next to it, it said, "We have the following number of employees." I believe the number was like 25. Well, if you're not looking for it, you're probably not going to pick it up. When you think normally $8,000 a year, I don't care what year this is that you're listening to this tape. Twenty-five people at $8,000 isn't much.

And, what we had was we had a person that was working there part time, and the other people that we had mentioned on this list were people that were working there for nothing. They were friends, relatives, most of them were relatives of the owners. The owners were in their mid to late 80s. They were very sick, very old, and the grandkids, nieces and nephews and everybody in the family was working there for nothing. Why? Because grandma and grandpa were in the process of making out their will or changing the will. Why do they work there? They are hoping they'd be favorably mentioned by grandma and grandpa.

Incidentally, as we took that business that was showing, again I don't remember the exact number, say $35-$40,000 net profit, and we built back in the different relatives and just did at the minimum wage that was in effect at that time, we realize that business went from almost $40,000 a year net to about $30-$40,000 in the red just on that one area. So, this is not just a minor thing. It's a major thing. Are you going to run into it quite often? Yes. Are owners going to tell you that they're doing this? No, because what owners are trying to do when they're working with a broker or they're working with a buyer, they're trying to tell you all the good news about the business. We call it creative embellishing. What is it also known as? Probably lying, but again, people tend to misrepresent the first couple of times when you're talking to them, and we usually find by the time we've talked to them a third or fourth time, we've established a repore.

We're getting much better answers. We're getting answers that are closer to the truth. It doesn't mean they're liars. It means they're trying to sell you something, and in their anxiety they bend the rules a little.

We talked about payroll taxes and I've built that in already into the manager's salary. Let's go down to auto expense. Annual auto expense – what we have is we have an automobile and the expenses on the profit and loss if you look under operating expenses come to what? $12,400. Now, we took $12,400 here what we have is $8,000 that aren't legitimate. So, we have $8,000 not legitimate out of the $12,400.

The thing of this though is how does that happen? Well, this is not skimming. In other words, if an owner comes to me and tells me that he has a second and third set of books, the thing that always makes me laugh, the average owner doesn't even have a good first set of books. What we're going to find is they're doing a thing called skimming. It happens mostly with small business owners which means they're not running all the money through the books.

As you start to get into the larger businesses above $50,000, very few business owners are doing a thing called skimming, and the reason they're not doing that is there are three or four people working in their accounting department, and if they do go out and start to play games, they have three or four witnesses which end up with lifetime income because you can't afford to get rid of them because they'll turn you into IRS. So, the average owner of a business over $50,000 cheats on their expenses. It's not that they're better people.

They're just cheating in a different area, and one of the areas that they cheat in is auto expense. IRS has very definite rules that have to do with auto expense, and it has to do with what percentage of your car you can use in the business and whether you can tie in every car you have in the family, and what we find on the average, and it's not that much exaggerated, the average business owner will write-off their company car, and they'll write-off every other car they have, and even though they're not using it 100%, they're writing it off 100%. In fact, they keep teasing about the fact that if they don't have enough cars, they'll make up cars.

For this example right here, we do have an example of tax cheating. Well, you can decide for yourself. In this example right here, we have two children – the owner's children, they're going to college. They're expenses come to $8,000 a year on their automobiles. Now, this is not skimming. This is expense Mickey Mouse, and what you're going to find is you or your CPA can go back to the books and in most cases the owner will have this isolated. You can actually dig it out. For you IRS agents listening, you can do the same thing.

You're going to find that they have this excess auto expense, and as you go through it you're going to find the kids are going to college. The question you should ask is, "Do they work for the company?" No. Since they don't work for the company, is that legitimate? No. Do business owners do this? Yes.

You start to go out after listening to this tape program, what I'm trying to do on this tape is explain the real world to you because as you go out the next week or the next couple of days to look at businesses, what you're going to find is exactly what I'm telling you about, and again I'm not trying to train you to become a tax cheat. What I'm trying to train you to do is go out and analyze business properly and if you don't understand what the real world is, you're never going to make it, and you better start to realize they're doing this. Don't be shocked. This doesn't mean you should be copying or doing the same thing, but don't be shocked at what's going on.

For those of you non-believers that don't believe this tape, why don't you sit down with your favorite IRS agent and let them talk to you about the problems they have or read some of the material.

Travel and transportation, as you look at the travel and transportation, you're going to find that travel comes to $24,900, about the second item from the bottom under operating expenses, and as you look at 3-9, you're going to find the travel and transportation they number that we have built in is $19,700. What does that mean? That means of the $24,900 of travel, $19,700 is either not legitimate or are expenses that you may not have to get involved in.

In this example right here, you're going to find that grandma and grandpa or mom and pop that happen to own this business, happen to be doing business in the Far East. Do they have contacts over there? No. Do they buy things over there? No. What do they do? They document, and you're going to find a normal business owner has the mentality, "If I don't get audited, I don't have to worry about it." I'm not saying that's right or wrong, but all I'm trying to explain on this tape and this is a very dangerous area and a very narrow line I'm trying to walk right there. I have to give you the information, but I don't want you to get the wrong idea. You have to stay away from the tax cheating or you'll get in trouble with the IRS.

Now, the thing I want you to realize as you look at this, you're going to find this in a number of businesses. Does they happen quite often? Yes, it does, and that's what IRS looks out for and on their audit, but the key thing is documentation. The key thing from your standpoint in analyzing a business is it a legitimate expense? It's an expense that you as a new owner or the person analyzing a business can build back in as part of the profit. It's an expense that's non-recurring. It's an expense that you don't have to have in the business other than you're looking for the trips to the Far East and you want the IRS or the government to pay for it. But, from the basic standpoint, this is not legitimate this $19,700 is not legitimate.

The next category we have here – we're going to talk about pension and profit-sharing, you'll find this coming up, and we find again, if it's pension and profit-sharing for the owner of the business fine, you can add that as part of the money that that corporation has. Now, keep in mind as you're going through this and we'll go through this in another section, although these are dollars that are available to add back into this business for valuation, it doesn't mean that all these dollars will be available to pay loans or to feed you and your kids later. Again, we'll talk about that later as we get to the section on cash flow.

The next area we talk about health insurance, we're talking about a thing that's called business, that's legitimate, and we get into health and life, and you're going to find this example here, we take the whole $16,600 and add it back in. The reason for that is there are laws in this country that keep changing from year to year, and it has to do with the form of ownership of a company whether it's corporation or personal and also whether the benefit programs you're setting are health insurance and life insurance are just for you the owner or for everyone.

In this example right here and analyzing it, we found out that of all the health and life insurance programs that they're writing off, not one of them was legitimate. Now, I don't want you to get the feeling that you don't want to or don't have to give your employees health benefits or life insurance benefits. The key thing to do is sit down with an insurance broker or insurance company. Find out if it's legitimate. Your CPA is going to be able to tell you the same thing. If you're going to set the thing up why don't you set the thing up right?

But, in this example right here, what we have is $16,600 which is an expense to the business that you're going to add back in. Why? Because the owner has developed his own program. In this example, we have own that's not legitimate tax wise. Was it a mistake? I don't know. That's up to IRS to figure out, not me.

As you start to go down, let's go back and finish up the example and you'll find if you take the $50,000 net. We had a $50,000 net profit. We add that in at the top, or excuse me from the top, and you'll see on the bottom it says, "Net profit $50,000". Below it says additions. If you'll add up all the additions to net profit from our first column there, it comes to $124,300. If you then subtract the deductions you have and in this example it was a manager's salary, son of a gun, you end up with an adjusted net profit available to the new owner of $132,300.

Now, again, as I've told in the example before, we have found over the years that this is a little below the average and if you're looking at the average business we've run into, you would find that although it's paying tax on $50,000, there's another $100-$150,000. So, the number you find under the adjusted net profit would not be only $132, you'd find it would be somewhere adjusted, somewhere between $150 and $200,000. Again, is all this available to pay your bills and feed your family? No, they aren't, and we'll talk about that later when we get into the section on cash flow.