

"This is a good overview. It's really. The book shows they can work together to figure out success or entrepreneurship." —
Paula Lopez, Co-Founder, PlanIt! The Green Franchise, pp. 146-147

The Educated Franchisee



The How-To Book for
Choosing a Winning Franchise.

By
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Written with Mike Kohler

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Chapter 5

Why Own A Business When I Can Get A Job?

*Two roads diverged in a wood, and I ...
I took the one less traveled by,
And that has made all the difference.*
— Robert Frost

It's one of the most common questions that people ask as they think about whether to go into business.

Many prospective entrepreneurs come from a corporate background, and corporate America does not teach or promote the concepts of ownership or entrepreneurship. In fact, corporations want to shield their most valuable assets, their people, because companies strive to retain valuable employees.

Corporations love to talk to their employees about the value of company cars, club memberships and health care packages, but they're not going to talk to you about the value of owning a business.

As I've worked with people over the years, I regularly see the red flags that signal corporate employee mentality. As we open the discussion of what they want to get out of business ownership, they'll say things like:

"I need a salary of \$100,000."

“I want a business where I can pay myself immediately.”

When I hear those comments, I know they have not been educated about the concept of ownership. It’s time now to examine the mentality of business owners and *why* people own businesses.

We’ll examine the logic of business ownership as an asset creation model. As you look at the side-by-side employee vs. business owner comparison, you’ll need to shift to a new paradigm, particularly if your only professional history is in a corporate setting as a salaried employee. The way you view the expression of “how much do you make” must change in order to understand the asset building model.

OWNER VS. EMPLOYEE MENTALITY

The argument for ownership over employee status is similar to the case for owning versus renting your home. The great American dream, of course, is to own your own home. Why? Not just for the perceived security of it, although the psychology is understandable, but the stronger, more logical, reason: you’re growing an asset that ultimately works for you.

Do you own a home? If you’re considering business ownership, the chances are likely you do. So think about your home ownership for a moment. What are the advantages of owning your home? The most common responses to that question include:

- I’m not going to just hand over my money for someone else’s benefit every month.
- I want something that belongs to me and can be passed along to the next generation.
- If my home is paid for, I’ll always have a place to live.
- I want to invest in something that will appreciate in value.

And that final point is what brings me to the underlying theme of the case for business ownership as the American Dream, Part II—owning a business and creating wealth.

Conversely, entitlement is the underlying concept of being an employee.

In the employer/employee relationship, there is an element of gifting involved. Employees look forward to bonus awards as rewards for their hard work and dedication to the employer. That mentality is pervasive. But what happens if the bonus isn't there, or isn't as large as one had hoped? Things can get pretty ugly if the expected sizable payout isn't given at the end of the first quarter.

If you've been an employee in a company of any size, think of situations in which you questioned why something was being done. You did it because it was mandated by the owner. In such situations, the owner was probably thinking in an asset-building context, while your mind was fixed in the context of getting more and better resources for your division.

For employees, the inclination is to seek resources that will make things operate more smoothly and make work conditions more pleasing. Owners employ a broader vision and understand that sacrifice has to be made in the short run in order to build an asset and achieve greater security in the long run.

Let's look at home ownership again. One often must forgo immediate gratification in order to buy a house. That is what my parents did when they looked at owning their first home after immigrating to America. They had lived here for about 18 months, and my mother was homesick and longed for a visit back home. My father came to my mother and posed this situation to her, "We've saved a little bit of money, and we have a choice to make. We can put the money down on a home, or you can go back to Europe for the summer. What would you like to do?"

They couldn't do both. They had to choose between investing in asset creation or addressing an immediate psychological need. They elected to go back to Europe, and consequently their investment in a home was postponed. That was the tradeoff. They recognized the tradeoff and had to live with that decision.

It is likely that we have to forgo some level of gratification to buy a house. Then, when the house is purchased, additional sacrifices and investments are required. You have maintenance issues, you have tax issues, you have insurance issues—a whole range of expenses we willingly incur because we know owning a home can create value.

That's the same mentality you must have when you look at investing in a business and that is why most people who own businesses generally also own their homes. If asset creation isn't a compelling objective, then having a job is just fine.

THE CASE FOR OWNERSHIP: WHO REALLY MAKES MORE MONEY?

The following example demonstrates the relative differences between business ownership and a job. Let's compare three years as a business owner versus the same time as an employee. The objective of this example is to open your eyes to the relative give-and-take of each approach. It will also help you understand both how business owners think and how to explore wealth creation.

The accompanying charts illustrate the case. Let's study the comparison of a startup business in the first three years to a six-figure corporate job over the same time period. It is The Entrepreneur vs. The Employee.

► **Year 1**

	Entrepreneur	Employee
Startup investment	\$150,000	\$0
Year 1	\$200,000 Gross 10% Net \$20,000 Owner Benefit	\$100,000 salary

At the start of Year 1, The Entrepreneur invests \$150,000 to launch the new business. For the purpose of this case study, the source of the startup funds is not relevant. The investment capital could come from home equity, a 401K rollover, a bank loan or a relative. All we need to know is that \$150,000 is invested.

Meanwhile, The Employee invests nothing, incurring no debt or risk. If anything, The Employee invested a bit of time and copier expense in preparing a good resume.

Over the course of the first year, let's see what benefits the two of them realized:

In the first year The Employee has a pretty big advantage in terms of income, with a salary that clearly exceeds the \$20,000 owner benefit The Entrepreneur takes from the business. In Year 1 there is no arguing the fact a six-figure salary, even after taxes, exceeds the \$20,000 owner benefit by quite a margin. The Entrepreneur must be willing to accept this, just as a homeowner accepts the fact he has higher expenses in the first year than the renter.

Of course, many people would discuss the intangible benefits. The business owner, even in a challenging first year, gains an appreciation of the freedom and pride associated with controlling his own destiny. A franchisee I coached reported with satisfaction that he was playing a lot less golf than he did during his corporate career. He proudly stated it was his choice.

Intangibles are not enough to make the case for ownership. Although they are important influences on the emotional side of the ledger, they do not explain wealth creation. On the logical, practical side, it is important to take note of the dollars-and-cents trends taking shape.

For example, the tax ramifications yield a different picture. Owner benefit is worth more than you would expect because of how you are taxed. When The Entrepreneur decides to buy a \$30,000 car, it can be purchased directly as a business expense and comes straight out of the business. For The Employee, buying the same car requires more salary dollars, probably \$40,000 or more, because earnings are taxed first.

The same would apply to expenses like daycare. The Entrepreneur may incur \$5,000 in daycare expense, and it is covered directly by the business because it is an allowed deduction. Once again, The Employee has to earn somewhere around \$8,000 to pay for the same amount of daycare because of the tax implications. In the end it just makes sense to pay for things with pretax dollars if you are legally eligible to do so.

One thing many people don't realize is the government actually wants to stimulate the health of small business and offers many tax advantages toward that goal. Advantages that are not only legal and permissible, but strongly encouraged.

Again, this view is not intended to suggest The Entrepreneur's Year 1 owner benefit is equal to or better than the six-figure salary. The point of this comparison is that you have to look at how dollars work.

As you consider business ownership, you may say, “I want to make a \$100,000 salary.” Actually, what you want to make is the owner benefit **equivalent to** the buying power of a six-figure salary.

► **Year 2**

	Entrepreneur	Employee
Startup investment	\$150,000	\$0
Year 1	\$200,000 Gross 10% Net \$20,000 Owner Benefit	\$100,000 salary
Year 2	\$350,000 Gross 15% Net \$52,500 Owner Benefit	\$105,000

In Year 2, things improve for both The Entrepreneur and The Employee. The Employee received a very nice raise of 5%, and now has a salary of \$105,000 annually.

Meanwhile, The Entrepreneur has done better in the business. His gross revenues have increased from \$200,000 to \$350,000 and his net income percentage has increased from 10% to 15%—but look at what has happened to his owner benefit. Because of the healthy boost of gross revenues and greater efficiency, owner benefit has now more than doubled from Year 1 from \$20,000 to \$52,500.

Still, The Employee has an advantage in take-home dollars, but The Entrepreneur is building a business. He has more than doubled the owner benefit and is building the foundation for future growth.

At this point, someone may point out companies furnish great benefit packages for their employees, pointing to 401K and medical insurance packages. Those are nice benefits, but are those benefits only available through large corporations? Of course not!

In a typical corporate 401K program, the company generously matches up to, say, 8% of the employee’s contribution. The employee’s contribution is typically capped at a certain level as well. While that may seem very generous of the corporation, The Entrepreneur isn’t bound by those limits. As an independent business owner, you can drive a lot more money into your retirement program because you are able to determine the way your program is set up. In one year, I protected

more than 100% of my salary through the establishment of various retirement programs!

That's the beauty of owner benefit. The owner decides what to do with that benefit – reinvest it in the business, pay down debt with it or use it for personal expenses.

Speaking of significant personal expenses, health care expense is always a major priority for any household. In corporations today, health care is certainly the subject of much discussion. Companies are requiring their employees to spend more on health care, and we're definitely seeing a trend toward health care programs with higher deductibles. Yet many people worry about finding affordable health care insurance and assume large group plans with large corporations are the only safe havens for quality health insurance benefits.

Entrepreneurs are discovering high-deductible plans that are affordable, offer good coverage for catastrophic events and have great tax advantages, either as plans offered by the company or as personal plans that are tax-deductible. Group insurance plans are not exclusively for large companies, as a group can be defined as two or more employees in a company.

Along those lines, take a glance at the healthy trend for The Entrepreneur in Year 2 and keep an eye on the percentage increase in owner benefit line as we continue to Year 3.

► Year 3

	Entrepreneur	Employee
Startup investment	\$150,000	\$0
Year 1	\$200,000 Gross 10% Net \$20,000 Owner Benefit	\$100,000 salary
Year 2	\$350,000 Gross 15% Net \$52,500 Owner Benefit	\$105,000 salary
Year 3	\$450,000 Gross 20% Net \$90,000 Owner Benefit	\$108,000 salary

Once again, The Employee was a good employee and was rewarded with another salary increase. His \$108,000 pre-tax gross salary exceeds The Entrepreneur's owner benefit. But the gap is narrowing. In two years The Entrepreneur has gone from \$20,000 to \$90,000 in Owner Benefit. Who achieved the greater hike in earnings? The Entrepreneur again.

In terms of take-home dollars, The Entrepreneur has at least evened the score, and possibly surpassed The Employee in regard to after tax, net purchasing power.

CREATION OF AN ASSET

This brings us to the most salient point of this entire exercise. Let's compare the asset value The Entrepreneur has created versus the asset value of The Employee's job.

	Entrepreneur	Employee
Startup investment	\$150,000	\$0
Year 1	\$200,000 Gross 10% Net \$20,000 Owner Benefit	\$100,000 salary
Year 2	\$350,000 Gross 15% Net \$52,500 Owner Benefit	\$105,000 salary
Year 3	\$450,000 Gross 20% Net \$90,000 Owner Benefit	\$108,000 salary
Owner's Business	+/- \$270,000	\$0

The Employee's job has an asset value of ZERO! Think about it. Does an employee *own* a job? No. Does an employee own their office or work station? Someone else owns these assets—the business owner!

Speaking of our entrepreneur, look at what happened to the market value of the asset that was created with a \$150,000 investment. Because The Entrepreneur worked hard and created a successful business, he can now sell the business if he wishes.

What is the value of this business? It is hard to say, but a reasonable rule of thumb is 3 to 3.5 X owner's discretionary profit (or owner benefit). In this situation, the business would probably be worth around \$250,000 to \$300,000.

Valuation of existing businesses can be performed in a number of ways, with various criteria, including multiples of cash flow. It is likely the positive growth trend and the positive cash flow of this business in our case study would be quite attractive to prospective business buyers.

WEALTH CREATION

In the end, asset building is about wealth creation. It is about increasing your net worth. At the start of the exercise, the \$150,000 investment seemed like a significant setback for The Entrepreneur, while The Employee enjoyed the comfort and ease of settling into a new office to work for a steady paycheck.

Within three years The Entrepreneur had built both cash flow and asset value that exceeded The Employee. This is just the start of the story. Now The Entrepreneur can begin to leverage growth. In the third year The Entrepreneur opens a second location, and in the sixth year he opens a third store. At the end of ten years, all three locations are stable and well established. What has The Entrepreneur created? **How about a cash flow of more than \$250,000/year, and more importantly, a business that is worth almost a million dollars!**

This is how wealth is created in a free market economy. Someone invests their capital and builds something of value. That thing of value is desired by others and the value of the item goes up. As the value goes up, the individual becomes wealthy. If you don't believe me, research almost any multi-millionaire. As a matter of fact, start with the billionaires. Bill Gates' salary is less than \$1 million per year. How did he amass a \$42 billion dollar net worth? He created something of value called Microsoft.

There is an entire book on the subject of wealth creation called *The Millionaire Next Door* by Thomas J. Stanley, PhD, and William D. Danko, PhD. The majority of millionaires in the United States are millionaires due to the businesses they built, not because of the salaries they earned. They state, "In America, fewer than one in five households, or about 18%, is headed by a self-employed business owner or professional. **But these self-employed people are four times more likely to be millionaires than those who work for others.**"

If part of your vision is to build a significant net worth, allowing you the freedom to pursue the other things in life that are important to you, then business ownership is a path to seriously consider.

SUMMARY

Making the leap from employee to owner involves two dramatic shifts in your thinking:

- 1) Shift from the “salary mentality” of an employee to the “cash flow and asset creation mentality” of an owner.
- 2) Your technical analysis of how much you make must be based on the complete picture of costs and benefits.

All employees, whether front-line or CEO, sell their labor and skills to the owner of the business. The owner, in turn, rewards employees with compensation. No matter how high on the organizational chart, employees are essentially renting their time and skills to an owner. The owner is using the work and skills of the employee to build something of value that the owner can then grow and/or sell.

An employee has very little financial risk in this equation. The major risk is the ability to retain the job and make future income. The employee does not risk their savings in a traditional employee/employer relationship. As you would expect, low risk generally limits your upside potential.

Owners take on more risk. They invest savings to create a business and risk the business not performing to the level they expect. But the owner also derives the majority of the benefit should the enterprise prove to be successful. Once the business is established, they gain security of cash flow, tax benefits and asset creation.

Even though this is a basic risk/reward equation, it is the very foundation of wealth creation in a free market economy.

This Chapter is provided to you courtesy of *The Educated Franchisee: The How-To Book for Choosing a Winning Franchise*. Should you wish to learn more, you can purchase a copy of the book at www.educatedfranchisee.com or at www.amazon.com.

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