Are You Paying Yourself What You're Worth?

Owners of small businesses often make the mistake of undervaluing both their time and their monetary investments in their businesses. As a small business owner, you almost always fill two roles in your business: (1) as an employee, and (2) as an investor. Unfortunately, most owners only pay themselves for the former role, and even then, it's usually at below-market rates.

As an Employee

If you work in your business, you deserve to be paid as an employee. After all, you could just as easily work for someone else and collect a paycheck. Therefore, the wage you pay yourself should be comparable to what you would expect to pay someone else to replace you. For example, if you own a restaurant and currently fill the role of General Manager, you should draw a salary commensurate with other restaurant general managers in your area: typically $40,000 - $60,000 per year, adjusted up or down depending on the size of your operation, its location (urban vs. rural), and your level of skill/expertise.

Some owners will pay themselves below-market rates while they "try to grow the business." I would caution against that, however. If you sacrifice five years of your life to "growing your business" and it doesn't grow, you will have nothing to show for it. A much better (and safer) strategy is to pay yourself reasonably from the beginning; that way, if the business does not succeed, at least you were paid for your time and efforts. Much like the investing tenet of "never put all of your eggs in one basket," resist the temptation to tie your own financial success or ruin to just one thing (e.g., your business). Furthermore, if the business can only succeed if you pay yourself below-market wages or no wages at all, then you really don't have a business – you have a hobby.

If you think that your business cannot afford you, consider paying someone else to replace you. In the above example, if you feel that you are worth $100,000 a year based on your skills and experience, but your restaurant can only afford to pay a general manager $40,000 per year, hire someone else to fill that role in your business, and find a higher-paying job somewhere else for yourself. That way, you will still be an investor in a potentially successful restaurant, yet have a stable income from an unrelated source.

As an Investor

Paying yourself a reasonable, market-rate wage is only part of your total compensation, however. As a small business owner, you must also think of yourself as an investor in your business. If a friend asked to borrow $250,000 from you to start a restaurant, would you be okay with him never paying you back? Even if he were to pay you back, would you offer him a thirty-year, 0% interest rate loan? For most people, the answer to either of these questions would be a resounding "no," yet the small business owner thinks nothing of doing just that to himself. If you invested $250,000 in your business, then your business had better be paying you back, and not just with principal payments, either. Otherwise, you could just as easily have invested that money in something else. For comparison, the 70-year average annual return of the U.S. stock market is around 10%, and most financial advisors will tell you that expecting at least a 4%-6% annual return from a mix of treasuries, municipal bonds, corporate bonds, stock dividends, and stock appreciation is **extremely** conservative. Right now, banks won't lend money to even large, healthy businesses at less than 5%, and I have yet to see a credit card with a rate significantly below 9% APR, even for those individuals with FICO scores over 800. Venture capitalists won't touch a project without at least a 20% or higher projected annual return on investment, and are often looking for opportunities to double their money within 2-3 years. Why then, would you accept almost zero percent from your high-risk business, while outside investors are requiring 20% or more? First and foremost, your business should be a financial investment, not a hobby, not a charity, and certainly not a tax write-off. I continue to maintain my belief that any business you own should pay you at least 10%-15% on your investment, regardless of your actual involvement in the company (remember our discussion earlier – you will get paid separately for your involvement as an employee). If your business cannot do that, then consider investing your money elsewhere such as in index funds or low-fee mutual funds instead.

Putting it all Together

When looking back at our restaurant example, I would expect to see the following:

- Annual salary of $40,000 as the General Manager
- Annual payments of $40,000 as an Investor

Total compensation: $80,000 per year.

That is the minimum that you should expect to open up our hypothetical restaurant. This salary as a General Manager is on the low end of our scale, and the monthly payments of $3300 correspond to the ten-year repayment schedule of a $250,000 loan with a fixed interest rate of approximately 10%. Since restaurants are often viewed as high-risk businesses, you may want to seek a 20% or higher minimum return, although non-financial factors, such as the ability to set your own hours, be your own boss, do things the way you want to do them, and work with family members, may compensate for an otherwise low monetary return on investment.

From One Extreme to Another

Every once in awhile I come across an owner or group of owners who has gone too far in the other direction: demanding unreasonable compensation from a business. While the way you run your business is ultimately your prerogative, it is not there to be plundered indiscriminately by the owners, nor is it there to provide the lifestyle you aspire to without regard to viability. Where I see this most often is with family-owned or multiple-partner businesses. A restaurant generating $500,000 in annual revenues is barely able to provide a modest living for one owner, even in a good year; expecting that business to employ yourself, three of your friends from college, and your cousin, each at a $50,000 annual salary, is simply not possible – that's $250,000 in salaries, or half the business's annual revenues! A business that size would normally have one General Manager at $50,000, 1-2 assistant managers at $30,000 each, and then hourly help in the kitchen at up to $12/hour and descending to $4/hour (or less) plus tips for the wait staff. In a good year, the business should be able to produce a net income of 10%, or $50,000. However, there is room for only one GM, and not a high-paying position, at that. Just because your cousin works as the company's part-time bookkeeper doesn't mean he's entitled to $50,000 per year.

Whenever I am faced with a client such as this, I usually sit down with the primary owner and describe the following analogy. Imagine you are the executor of an estate that includes a restaurant as its primary asset. Everyone who worked in the restaurant had just died in a tragic fishing accident, and the only relative left to inherit the business is a four year old child. Your job as trustee is to re-staff the business with competent people and make it profitable, thus enabling the estate to sell the business and use the proceeds to provide for the child's future. When in the role of the hypothetical trustee, most people would try to do what was best for the child and not plunder the child's future, yet in the role of part-owner, plundering the child's future is exactly what some owners are doing by overstaffing their business. If unsustainable levels of cash are withdrawn from a business, it will eventually fail, and seldom has that plundered cash been put away for a rainy day. Instead, it usually has been spent on an unsustainable lifestyle and/or spread too thinly across too many people for too long.[1]

Conclusion

With any business venture, you must consider not only your own needs, but also the realistic expectations of the business. A hot-dog vending cart in a major city can produce a reasonable income for one person, but it cannot provide a lavish lifestyle for ten equal partners. Conversely, if you are the sole owner of a restaurant yielding over $2 million annually in revenues, you are cheating yourself by only drawing a modest salary. I challenge you to take a step back for a moment, imagine yourself working somewhere else at a fair market rate, and ask yourself, "If I could invest in this business at the interest rates it is currently paying its investors, would I?" and, "If this business offered me a job at the wages it is currently paying its managers, would I take it?" If you answered "no" to either of those questions, you are not paying yourself what you are worth.

About the Author:

Marshall Waters, a management consultant and former small business owner himself, has traveled extensively throughout the United States and Canada, advising over 70 small and mid-sized businesses on topics such as sales and management training, strategic planning, marketing strategy, and turnaround management. You can reach him via his website at: http://www.altonconsultinggroup.com

---

[1] I myself was lulled into joining a firm consisting essentially of myself and one other person, yet the other person insisted on including two other friends plus a family member, as equal partners in an attempt to "help them out." The firm had potential, but my 16% share of the firm's 10% profits was simply too small to justify my time. Apparently, the partners we were "helping out" must have felt the same way, as they never bothered to participate in the organization in any meaningful way.