

Peer Benchmarking: #1 Tool for Improving Your Business

What is possible?

The reality is, humans have a hard time figuring out what is possible.

The interesting thing is, the art of the possible is about envisioning the future, but humans really only move into the future by peeking into the past. It's just the way we work.

By way of explanation, to envision what is possible we rely almost exclusively on two things:

- Our own past performance
- Others' past performance

Virtually every development on earth is incremental. Evolution is incremental.

In sports, records are broken every day — in tiny increments. To break a record, the athlete's challenge does not require him/her to create a new reality. The athlete is not required to deliver a never-before-in-history performance. The bar is set much lower — simply edge **current** reality by a hair.

Consider as well that each of us is heavily influenced by psychological barriers that, by their very nature, are not real. They exist only in the mind.

Take the 4-minute mile as a case in point. Though generations of runners clipped second after second off the 4-minute-mile record without interruption — and steadily approached the 4-minute-mile mark — there was a widely accepted belief that it was not humanly possible to run a mile in fewer than 4 minutes. And so, as world-class milers approached the 4-minute-mile mark, the pace slowed. The only explanation for this is the psychological barrier. Self-doubt, if you will.

Runners came closer and closer to the mark, and then it happened. In 1954, Roger Bannister finally posted a time that began with a 3 (3 minutes and 59.4 seconds) and, in the ensuing months, the rest of the field burst through with their own times under 4 minutes.



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From the Editor

Signs of life in the economy? I sure think so. Personally, our office phones are ringing again and business seems to be getting back to normal. Yes, banks are lending, the newspapers are not 100% filled with doom and gloom and the stock market is well above its lows. Still, this issue speaks to those who may be struggling, namely, "Message to Business Owners Trying to Restructure" and "Success and Happiness Not for Wimps."



David L. Perkins, Jr.

This issue of *The Business Owner Journal* also speaks to those who are considering taking advantage of opportunities to pick up some distressed assets. After all, if you assume that good times will indeed return, there are likely some opportunities today to make some smart investments. If this is you, read "Buying a Business: Stock Purchase vs. Asset Purchase?" and "A Fool and His Money Are Soon Parted (Investing vs. Gambling)".

Finally, this issue continues our series on cost reduction and profit enhancement strategies. The feature is "Peer Benchmarking." If you are not doing it, add it to your list of priorities. I hope the articles herein will help convince you to do so.

To be sure, this issue contains a bevy of practical and motivating articles for you and only you — the business owner. Yes, you can grow your business profits. We can help.

Regards,



David L. Perkins, Jr.
Publisher and Editor

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RISK MANAGEMENT

Employee Non-Compete, Non-Solicitation and Anti-Piracy Agreements

Business owners who have non-compete and/or non-solicitation agreements in place with their employees should resist the temptation to place unmerited reliance on their usefulness and enforceability, that is, as a means for protecting against loss that could result from the departure of, and eventual direct competition from, a key employee. Business owners would also be well served to familiarize themselves with the similarities and differences between non-compete and non-solicitation agreements, and the limitations of each.

Both types of agreements can be used in a sound, comprehensive risk minimization strategy, but business owners should take care to know how these agreements can and should be used, and their limitations, which are considerable.

Both are interpreted by, and under, applicable state laws. This means that the state laws under which any particular agreement is interpreted is all-important with respect to utility and enforceability. For example, in Florida, such agreements are considered enforceable under many circumstances, while California laws strictly prohibit non-compete agreements and render them void. In Oklahoma, non-solicitation agreements are enforceable, while non-competes are not.

First, if you don't have agreements such as these in place with your employees, read this article. Then talk to your legal counsel and determine their enforceability under the state where your employees work, and determine whether getting them in place is best for you. If you do have such agreements in place, but your agreements are more than a few years old or, after reading this article you are unsure of their quality or suitability, talk to your legal counsel.

Second, as stated, non-compete and non-solicitation agreements are governed by, and interpreted under, state employment law, fair trade and free commerce laws, and contract law. These areas are complex and grant employees great liberties in their pursuit of gainful employment and their right to enter into free trade, commerce and productive enterprise. Court dockets throughout the United States are filled with rulings whereby non-compete and non-solicitation agreements have been rendered null and void, leaving employers with virtually no recourse or protection against employees who have departed and competed — in many cases, causing considerable harm to their former employers.

Crafting Agreements with Higher Odds of Enforceability.

Most unenforceability rulings are rendered due to language that is overly broad or unlawfully limiting on the employee's rights and freedoms. In contrast, some state courts **have** upheld agreements that place narrower limits on an employee's right to compete against his/

Business owners who have non-compete and/or non-solicitation agreements in place with their employees should resist the temptation to place unmerited reliance on their usefulness and enforceability.

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Employee Non-Compete, Non-Solicitation and Anti-Piracy Agreements, continued from page 3

her former employer. For this reason, business owners who wish to obtain some protection in these areas would be wise to use agreements that are narrower in scope and thereby have greater odds of being upheld by a court of law (or arbitrator), if challenged.

Anti-Piracy Agreements. An “anti-piracy” agreement is similar to a non-compete agreement but is much narrower. It attempts to restrict the terminated or departed employee from soliciting customers of his/her former employer and from making use of confidential information of his/her former employer. Because it is less restrictive on the employee, and less of a restraint on free trade, courts have been more willing to uphold it. As such, most employment law attorneys now suggest that employers use anti-piracy-type agreements. State courts across the United States feel that employees should not be restricted from engaging in the very business of the employer that they left.

Non-Solicitation Agreements. A non-solicitation agreement is even narrower than the anti-piracy agreement. It restricts the departed employee from soliciting business from established customers of the former employer but does not address the employee’s potential use of the former employer’s confidential information. These are generally enforceable so long as they are properly drafted and contain appropriate limitations.

Confidentiality Agreements.

A confidentiality agreement is just that, an agreement by the employee not to disclose the employer’s sensitive and confidential information. These are enforceable agreements.

Multipronged Strategy Is Merited.

Legal agreements should be just one part of a business owner’s strategy to protect his/her business from harm that could result from the departure of, and competition from, a departed employee. To be sure, protecting oneself from risks of this nature is difficult. Almost every business has employees who know the “secret sauce” or “the code,” or have long and deep relationships with important customers. Risk mitigation strategies that go beyond the legal agreement might include:

- > Don’t allow any employee to know, or have access to, “the code” (so to speak). For example, Coca-Cola goes to great lengths to protect the Coke formula. In fact, it is my understanding that NO single employee has access to the formula.
- > Limit the percentage of revenue secured or handled by any single person — such as a salesperson — whether he/she is an employee or independent representative.
- > You, the business owner, should maintain a close, friendly relationship with each key customer. Similarly, establish your business practices such that more than one employee maintains a relationship with, or works with, each customer. In other words, don’t get into the situation where customer relationships rest primarily with just one of your employees. One idea is that if you have multiple salespersons, periodically rotate the ones assigned to each client.

Maybe you have other ideas for effectively dealing with these risks? Please send them to me and we’ll share them with our readers in future issues.

Be Prepared for Vehement Employee Resistance.

Salespeople like power. Virtually all people try to gain and retain power. It’s human nature, a protective instinct. It feeds our natural desire for security. So salespersons naturally like and want to hold the bulk of the close relationships with customers.

When you implement changes that diminish an employee’s or representative’s power, he/she will resist. Some will resist vehemently, even quit or threaten to quit. Of course, the extent of the resistance will reveal the extent of your vulnerability. My suggestion is that you fight the battle today rather than continue to live with the risk and eventually suffer the consequences. I call things like this the path to “building a real business.”

If we want to build a business that is stable and enduring, we have to be willing to take action on important issues such as risks associated with employee departures.

Finally, employment agreements — or at least non-solicitation and/or anti-piracy agreements — can play a vital role in protecting your company. Talk to a skilled, respected attorney specializing in employment law about your particular situation, and don’t even dream of trying to establish an agreement on your own.

Michael Lissau, employment law specialist with the law firm of Hall Estill, generously provided his expertise for this article. Other resources used include:

“West Virginia Supreme Court Upholds Validity of Non-Piracy Agreements in Employment Contracts,” by Gerard Stowers of Bowles Rice McDavid Graff & Love LLP, headquartered in Charleston, West Virginia.

“Covenants Against Competition in Franchise Agreements,” Second Edition, 2004, American Bar Association, Second Edition, Peter J. Klarfeld, Editor □

MANAGEMENT

Peer Benchmarking: #1 Tool for Improving Your Business, continued from cover

So goes the business world. Business people are obsessed with learning the accomplishments of others. Why? Because we are unsure of whether we can do such and such until we see that someone else has.

If you can, then maybe I can. And when we meet someone who accomplished X, Y or Z, we’re further emboldened. Why? He/she doesn’t look any more special than me!

Peer Benchmarking is about looking at what other companies similar to yours are doing. If you, as a business owner, can match the best of your peers in key categories such as inventory turns, collection rates, gross profit margins, labor productivity, etc., then you will secure your place in the 20% that enjoy all the spoils. Where do you find peer data? Try your industry, trade association or the Risk Management Association (formerly known as Robert Morris Associates). □

Peer Benchmarking: How to Get Started

If they can do it, we can too, right?

How are they getting seven inventory turns per year? Average receivables days-on-hand of 37? Revenue of \$3 million on just \$250,000 in working capital? Occupancy expense of just 9% of revenue? 46% gross profit margins?!

First of all, if it's possible, I want to find out.

Second, if another firm IS achieving these things, I want to know how so I can put it in place in my business.

Peer benchmarking may be the #1 tool available for business owners wanting to improve the performance of their business. It's simply an exercise in studying the financial performance of the companies in your industry and comparing them to your own.

Is this kind of information available? In most cases, the answer is yes. The first place to look is your industry or trade association. Call the executive director and inquire. If they don't currently gather and publish peer data, launch an initiative to get this important member benefit in place. It's not too hard. You get the members to agree to provide some basic data about their company along with financial statements, in a blind or confidential manner. Then somebody crunches the numbers, develops a report and publishes the data. Often, members who contributed the data get the report free while others have to pay a fairly handsome fee.

The second place to look is the Risk Management Association (RMA). I've been using RMA "Annual Statement Studies" data for years.

RMA is a not-for-profit that gathers the financial statements and relevant data of small and midsize private companies, aggregates them and publishes the results. A sample is provided herein.

The input data are provided by financial institutions such as banks that loan money to businesses and are members of RMA. The data are provided on a blind basis (i.e., identities of the businesses are not revealed), and the sole purpose is "to advance the use of sound risk principles in the financial services industry."

Comparing Peer Data to Your Company Data. Once you've obtained peer data,

the first task entails understanding them. You'll want to spend some time immersing yourself in the way the data are compiled and presented. It can get a little complex, but the investment of time and effort is well worth it.

Second, organize your own financial statements in a manner that mirrors the peer data you obtained. Calculate the various ratios in the same manner as the peer data.

Third, identify areas where your business appears to underperform. We use the word "appear" because there can be many explanations for a large deviation. Give much thought to the possible explanations. Obtain assistance from your accountant because accounting policy and/or methodology can be a key factor.

Fourth, identify which area, if improved, would have the greatest positive impact on your business.

Fifth, develop a strategy for improving your business' performance in the area you target. This may include spending time investigating how some of your peers achieve better results than you. A great way for doing this is to attend your trade show or industry conference

with peer data in hand. Ask around. Corner a few business owners and/or managers whom you respect or have in the past shown a willingness to be open and helpful. Make it your priority to leave the event with answers.

Sixth, track your company's progress. Garner your employees' support and assistance. Involve them in the pursuit of improvement, if not peer-leading performance. Set goals and consider offering incentives.

I'm completely convinced that peer benchmarking is vastly underused in the business world. But that's good for you and me. If all of our competitors were on the ball, we'd have a much more challenging row to hoe.

This article is the third in a nine-part series on Cost Reduction and Profit Enhancement Strategies. See samples of RMA data on the next page. □

Peer benchmarking may be the #1 tool available for business owners wanting to improve the performance of their business.

The Business Owner Series on Cost Reduction and Profit Enhancement Strategies

January-February 2009 Issue:

- > Profit Enhancement Through Cost Reduction: The Time Is Now
- > First Step Toward Profit Enhancement? Break Down Employee Resistance
- > Cost Drivers and Where to Look to Lower Cost
- > Want to Improve Profit? Everything's Negotiable

March-April 2009:

- > Optimize Your Organizational Structure to Eliminate Waste, Increase Profit
- > Cost Reduction: Setting Priorities and Where to Look First

▶ This Issue, May-June 2009 issue:

- > Peer Benchmarking: Compare Your Company to Others, Find Out What's Possible

July-August 2009 Issue:

- > Internal Benchmarking: How to Use Your Company's Historical Performance Data to Enhance Profit

September-October 2009 issue:

- > Assess Organization-Wide Productivity to Maximize Profit

November-December 2009 issue:

- > Work Sampling: An Inexpensive Way to Assess Employee Productivity, Set Standards

January-February 2010 issue:

- > Using ABC Inventory Control to Carve Tax-Free Cash out of Inventory

March-April 2010 issue:

- > How to Improve Your Sales Forecasting

May-June 2010 issue:

- > Product and Service Pricing: Get It Right to Maximize Profit

Sample of RMA Statement Studies Data, 2 of 2

AGRICULTURE—Wheat Farming NAICS 111140										
Comparative Historical Data			Current Data Sorted by Sales							
27	26	35	Type of Statement	1	6	2	2	7	17	
16	21	24		Reviewed	3	2	6	7	6	
25	30	16	Compld	2	2	1	5	6		
31	44	19	Tax Returns	6	6	5	2	2		
68	63	70	Other	16	14	7	8	12	13	
4/1/05-3/31/06	4/1/06-3/31/07	4/1/07-3/31/08		37 (4/1-9/30/07)			127 (10/1/07-3/31/08)			
ALL	ALL	ALL	NUMBER OF STATEMENTS	0-1MM	1-3MM	3-5MM	5-10MM	10-25MM	25MM & OVER	
167	184	164		25	31	17	21	34	36	
%	%	%	ASSETS	%	%	%	%	%	%	
14.6	13.4	12.3	Cash & Equivalents	11.6	11.9	16.5	14.8	10.9	11.1	
21.7	18.1	20.5	Trade Receivables (net)	10.2	16.7	26.6	21.9	26.3	21.7	
19.0	15.7	15.4	Inventory	9.1	4.7	14.5	16.2	23.1	21.9	
4.6	3.2	4.3	All Other Current	1.3	5.3	6.8	4.2	3.5	5.3	
59.8	50.3	52.6	Total Current	32.1	38.6	64.4	57.2	63.8	60.0	
29.2	39.5	35.9	Fixed Assets (net)	57.7	46.5	18.9	33.3	26.5	30.1	
4.0	4.3	4.4	Intangibles (net)	7.0	5.0	5.6	5.0	2.1	3.3	
7.0	5.9	7.1	All Other Non-Current	3.2	9.9	11.1	4.5	7.6	8.7	
100.0	100.0	100.0	Total	100.0	100.0	100.0	100.0	100.0	100.0	
			LIABILITIES							
13.5	13.2	15.6	Notes Payable-Short Term	12.1	32.7	11.0	10.8	13.3	10.4	
2.2	3.8	3.7	Cur. Mat.-L.T.D.	3.0	3.0	3.9	4.7	3.5	4.4	
12.6	8.9	10.1	Trade Payables	5.0	3.0	16.0	12.7	13.6	12.0	
.2	.3	.5	Income Taxes Payable	.8	.0	.8	.6	.8	.1	
12.6	11.4	8.6	All Other Current	2.0	6.8	11.9	12.3	8.6	11.0	
41.2	37.5	38.5	Total Current	23.0	45.5	43.5	41.1	39.8	38.0	
22.3	23.4	25.0	Long-Term Debt	32.2	29.3	11.6	24.9	16.5	30.6	
.2	.2	.3	Deferred Taxes	.0	.0	.0	.3	.6	.6	
4.3	5.4	7.1	All Other Non-Current	13.2	5.9	3.7	3.4	10.2	4.6	
32.0	33.4	29.2	Net Worth	31.7	19.2	41.1	30.2	32.9	26.2	
100.0	100.0	100.0	Total Liabilities & Net Worth	100.0	100.0	100.0	100.0	100.0	100.0	
			INCOME DATA							
100.0	100.0	100.0	Net Sales	100.0	100.0	100.0	100.0	100.0	100.0	
88.5	88.8	86.5	Gross Profit							
11.5	11.2	13.5	Operating Expenses	69.2	80.5	88.3	94.1	90.3	94.5	
3.3	3.8	4.6	Operating Profit	30.8	19.5	11.7	5.9	9.7	5.5	
8.2	7.4	8.9	All Other Expenses (net)	14.3	6.5	2.2	1.7	2.3	1.5	
			Profit Before Taxes	16.5	13.0	9.4	4.2	7.3	4.1	
			RATIOS							
2.8	2.3	2.4	Current	3.1	3.3	2.6	2.2	2.6	2.2	
1.4	1.3	1.4		1.4	1.1	1.6	1.2	1.5	1.5	
1.0	.9	1.0	Quick	.5	.5	.9	1.0	1.2	1.1	
1.8	1.8	1.8		2.1	2.0	2.0	1.6	2.2	1.4	
(166)	.9	1.0		1.4	.9	1.0	.8	1.0	.9	
.3	.3	.4		.3	.1	.1	.5	.4	.6	
2	147.9	1	496.4	0	UND	0	UND	4	90.7	
30	12.3	23	16.2	28	13.1	0	UND	5	69.1	
52	7.1	55	6.6	53	6.9	20	18.2	39	9.5	
				15	24.6	49	7.5	71	5.1	
				55	6.6	62	5.9	52	7.0	
			Cost of Sales/Inventory							
			Cost of Sales/Payables							
4.8	5.7	4.7	Sales/Working Capital	3.4	4.2	6.4	7.3	3.2	5.7	
12.8	18.5	16.8		13.8	49.7	20.2	42.9	11.2	9.5	
-233.4	-70.7	-114.5	EBIT/Interest	-12.1	-15.5	-73.4	NM	172.0	44.1	
10.5	8.5	7.6		7.4	7.0	18.6	7.5	9.4	8.8	
(124)	3.6	(146)	3.4	(133)	3.4	(14)	4.3	(27)	2.5	
	1.5	1.5	Net Profit + Depr., Dep., Amort./Cur. Mat. L/T/D	1.3	1.2	1.5	(19)	3.4	(26)	
5.1	6.8	5.9		1.0	.5	.1	4	.1	.3	
(27)	2.0	(28)	1.9	(25)	2.5	.6	3.3	1.7	1.3	
.6	1.3	.8	Fixed/Worth	1.0	.5	.1	.4	.1	.3	
-1	.3	.3		3.3	1.7	.5	1.2	.6	1.0	
.7	1.1	1.2	Debt/Worth	46.6	-17.8	1.8	3.2	2.4	3.0	
4.1	5.2	4.8		.6	.4	.6	1.1	.9	.9	
.7	.7	.8	% Profit Before Taxes/Tangible Net Worth	4.9	2.3	1.7	2.3	2.0	2.6	
2.7	2.5	2.5		46.9	-20.1	33.8	7.9	6.1	6.4	
12.6	15.1	11.0	% Profit Before Taxes/Total Assets	56.5	37.0	67.0	98.7	46.1	39.6	
48.8	64.1	53.1		(21)	10.5	(23)	9.2	(14)	30.0	
(135)	23.5	(150)	23.7	(134)	20.3	4.9	4	6.1	20.2	
3.5	4.2	6.3	Sales/Net Fixed Assets	15.0	25.3	214.5	21.2	55.2	19.6	
15.5	15.1	15.8		1.6	2.9	16.2	7.3	14.3	10.2	
5.2	6.5	6.6	Sales/Total Assets	.2	.6	6.4	3.7	4.7	3.3	
1.0	.7	2.0		1.7	2.1	5.8	3.7	3.5	2.9	
60.4	28.8	31.0	% Depr., Dep., Amort./Sales	.7	1.1	2.0	2.5	2.0	2.1	
16.0	6.5	7.7		.8	.3	1.0	1.5	.9	1.3	
3.0	1.6	2.5	% Officers', Directors' Owners' Comp./Sales	.6	.9	.8	.3	.3	.6	
3.1	3.1	3.3		1.6	1.6	1.6	1.3	1.8	(29)	
1.7	1.7	1.7		(16)	7.8	(22)	4.6	(14)	1.6	
.8	.8	.9	Net Sales (\$)	21.6	8.3	4.1	5.1	3.7	3.3	
.6	.9	.8	Total Assets (\$)							
4.6	7.1	5.5								
1.9	1.3	.8								
(51)	3.8	(57)	2.7	(42)	3.1	7.0				
10.6	5.7	7.0								
5054232M	4999043M	5938124M		10630M	58499M	69185M	156396M	549373M	5094041M	
2587005M	3126190M	3618296M		30412M	226961M	51110M	121495M	512574M	2675744M	

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M = \$ thousand MM = \$ million

Message to Business Owners Trying to Restructure

Are you under extreme financial pressure? Desperate to restructure your debt (personal or business)?

First, try not to settle for simple short-term survival. Go for improving your situation for the long term. Yes, it is possible. Figure out how. You don't want to find yourself back in this same situation in a few years. To do this, you may have to be willing to play the "then let's just let this ship sink today" card. If the ship is going to sink, today is better than tomorrow. You know? If it's going to sink, let it be today so you can get on with your recovery and to a better place in a few years.

Second, keep in mind that your creditors are big boys and girls. They got into business with you in an arm's-length manner, knowing good and well that it might not turn out perfectly. And, unfortunately for all, it didn't. Your job now is to negotiate from here on your own behalf. Negotiate in the best interest of you and yours. Their job is to do the same for their own interest. All options are open for all parties. Negotiate for yourself with skill, courage, savvy and creativity.

Third, you have options. Get creative in identifying them. Some may not be very attractive, but put them on the table. Employ the good help of others you respect in listing each, along with

their pros and cons. Share them with your creditors along with how each would impact the creditor.

Fourth, the key to any restructure is held by your creditors. So, as with any negotiation, information is power. Get close to your creditors and gather all the information you can. Go to lunch with them. Make it a dinner or happy hour. Try to get them to talk to you candidly about their fears. About how they see the "credit." About how they view your options, their options, and the pros and cons of each.

Last, credit agreements are legal agreements. Obtain a copy of your legal agreement and study it. Understand every paragraph. Get any assistance you need because within those words you will find the powers granted to both you and them. Make sure you see the options available to you in the agreement and the limits imposed on them in the agreement.

To be sure, it's the moment of truth. When the goin' gets tough, the tough get goin'. So get goin'. □

Try not to settle for simple short-term survival. Go for improving your situation for the long term.

STRATEGIC

Competitive Intelligence: A Strategic Imperative

When your customers choose your firm, are they making the right choice? This question should **not** be offensive. As the owner of a small business, you should know the answer to this simple question, and your answer should be based on fact rather than bravado.

The design of an appropriate competitive strategy, as discussed regularly in this publication, requires that you know your competitors. For this, you need a competitive intelligence program. The cost does not have to be material and the time required can be modest. Most sources of data are free and readily available.

The first step to building your competitive intelligence is to find out basic information about your competitors:

- Who are they?
- Where are they located?
- What do they sell?
- How do they obtain customers?
- What types of customers do they attract?
- How many customers do they have?
- How loyal are each competitor's customers, and why?

Where can you find this type of information? Ask your salespersons. Then ask your current and prospective customers. Customers who buy or have bought from your competitors should offer fascinating insight. All will be flattered by your interest in and respect for what they say.

Once you have the list, fill in the details. Again, your salespersons and current and prospective customers should be a ready resource. Then, if feasible, order their products and analyze them objectively. At the very least, obtain and analyze the promotional materials. Or, better yet, have others assess the materials and/or products for you.

Next, find out which competitors have a website. Visit them and print out each page. If any are public, there will be a wealth of data available. Call the company, ask for their investor relations department and order the reports and press releases. Tell them you are a prospective investor — you are. Or go to www.sec.gov and you will find all of their filings.

Then search the Internet. Act like a customer and see what you find. What pertinent data are available? When

customers want to find out whom they should buy from, what do they find?

Finally, go a little further. Investigate the financial strength of private companies by ordering a Dun & Bradstreet report. Learn more by having an attorney search for legal filings, lawsuits, etc. on each. An hour on each competitor should be sufficient. You'll be amazed at what you will find. Separately, industry trade associations may have useful data as well.

When you've put this information together, you will feel empowered.

More important, you WILL be empowered — with knowledge that will enable you to improve your strategies, products, methods and materials. Share it with your employees. Talk about it. Everyone likes to be different, to be "special." Branding is about becoming different and special, in ways that matter to customers and prospects, so you now have the basis for developing your brand, offering something unique and, best of all, becoming more successful. □

The design of an appropriate competitive strategy requires that you know your competitors.

Sowing Seeds of Future Financial Demise

It is impossible to negotiate effectively when you have few, or no, options. If you are not willing to walk away. Dean Acheson, acclaimed Secretary of State in the Truman Administration, said:

"The single most powerful tool for winning a negotiation is the ability to get up and walk away from the table without a deal."

I've seen smart people all but seal their financial failure by failing to negotiate effectively. By being unwilling to walk away. For example, I've seen smart people want so badly to become business owners that they agree to unreasonable terms (i.e., terms of purchase of a business).

Sure, the buyer gets what he/she really wants — the keys to a business. In their minds, they have "arrived." Unfortunately, they also have sowed the seeds of their future failure.

So ironic.

Maybe more common is the business owner who agrees to unfavorable terms to obtain, or retain, the business of a sizeable customer.

In many of these cases, the business owner knows — consciously or subconsciously — that he/she so badly wants near-term victory that he/she is willing to overlook the inevitable: long-term trouble.

Don't **you** do it. Be committed to building a strong and sturdy foundation for long-term success, even if it means pain or humility today or delayed gratification. □

MARKETING

Can Your Contracts Also Help "Sell"?

What rules govern what can and cannot be put into an agreement or contract? To be binding, a contract simply must have an offer, acceptance and consideration. There are no rules on what it **cannot** contain. So why not add language that reaffirms why clients are hiring you and how they will benefit?

If you are one of these people who treat written agreements as some sort of sacred script that, once written, can be touched only by high priests (i.e., lawyers), stop taking them so darn seriously. Sure, agreements are important and, once signed, they document binding commitments. But feel free to work with them and rewrite them so they serve you better.

It is always good to keep agreements short and easy to read and understand, but allow some room to include summary language as to what clients want to accomplish, how you will help and why they are selecting you. Also add how clients will benefit if the goals are accomplished. Be careful, though, that your additions do not create additional promises, obligations or guarantees on your part.

If you are unsure about changes, talk to your lawyer. If he/she doesn't support your effort to improve the salesmanship of your agreements, consider finding a new lawyer. Shorter, friendlier and more simply written contracts that also reinforce client benefits will result in more signatures, clients and sales. □

Success and Happiness Not for Wimps

The business world is tough. Life is tough.

Success is not gained by wimps. Happiness is not bestowed on wimps. Success and happiness are found when you have the courage to face reality, embrace truth, admit fault and accept blame (publicly and privately), defend and protect yourself, take risk, accept failure, and get up and fight and try again. Let's add willingness to walk away when the deal is not good or the situation is not healthy.

Importantly, though, that business and life are tough does not mean that they cannot be wonderful. Beautiful. Fulfilling. It's just not for the faint of heart. It's not for people who are easily wounded, offended or deterred.

Similarly, that business and life are tough does not mean that you must be angry, ruthless or cutthroat. The sports world provides great examples. You can have the fierce competitive spirit of Tiger Woods and Michael Jordan and win big and also be a gentleman or lady. Have character and compassion.

At DL Perkins, LLC (and Acquisition Advisors), we don't hire wimps and we try not to keep clients who are wimps. It's one of our core principles. Life's too short to hang out with wimps. They're too high-maintenance. They quit when the going gets tough. You have to read their minds to know how what they want, because they're too wimpy to tell you straight up.

Winning companies are built from courageous leaders who hire talented and "strong" people to carry out their mission.

Winning teams cannot be crafted from a band of wimps.

Winning deals cannot be crafted when fear is prominent on your side of the table.

And listen, you'd be amazed at all the big and strong and successful business owners who — while skilled at covering it up — let fear and insecurity dominate their dealings. □

A Fool and His Money Are Soon Parted (Investing vs. Gambling)

The savvy investor — or, more aptly, the investor who survives and earns a fair return over the long term — knows the difference between investing and gambling. Webster's Dictionary says:

Invest means to commit money to earn a financial return.

Gamble means to play a game for money or property.

Notice the difference? Investing is a serious matter. It's business. It involves

The savvy investor — or, more aptly, the investor who survives and earns a fair return over the long term — knows the difference between investing and gambling.

commitment, and the purpose is to earn financial return. When you succeed and earn a profit, you are not surprised. In fact, the big surprise comes when you suffer a loss.

Gambling, on the other hand, is a game. It's not serious. It's for pleasure and the outcome is uncertain. In fact, the outcome is mostly a matter of chance. When you win, you say, "Oh, wow, that was great!" When you lose you say, "Well, such is expected."

Here are some additional distinctions.

Better Chance of Profit Than Loss.

Investments provide better odds for profit than loss, and this is determined by a reasoned, thorough and objective investigation of the facts. Of course, such an investigation on most games of chance leads one to conclude that the odds of loss are greater than the odds of profit. If you are considering a proposition and you do not have sound, fact-based reasons to conclude that a profit is likely, it's not an investment opportunity. It's gambling.

Quantity and Quality of Information.

The investor cannot, of course, determine whether an opportunity is worthy of his/her time and dollars unless he/she

is provided with all of the information he/she deems necessary to adequately assess the opportunity. This involves issues of quantity (i.e., information of adequate supply on every factor that could impact the prospective future returns) and quality (i.e., the degree to which the information provided or obtained can be relied on to be true, accurate and credible). If information about an investment is not available in adequate quantity or quality, the investor cannot conclude that the investment is suitable.

Performance History. Maybe the most vital piece of information is past performance history. For investments in businesses — whether publicly or privately held — this entails an analysis of the historical financial statements (i.e., income statements, balance sheets and statements of cash flows). The time horizon should be many years and, importantly, span a period of time that includes a recession (both in the industry in which the business operates and a broad economic downturn such as in 1973-1975, 1982, 2001 and 2008-2009). Only by analyzing performance during more challenging times can one really assess how the business might perform during such times in the future.

Speculation. Investments do not involve speculation, which is defined as the "assumption of unusual business risk in hopes of obtaining commensurate gain." Investments do not contain elements of hope. In contrast, investment decisions are based on a reasoned, thorough and objective assessment of the facts. If hope is at play in your decision to invest, what you're doing is gambling.

Capital Preservation. The ability to invest and earn income may be the greatest gift known to man this side of eternal salvation. To be able to earn income without the need to labor is what separates — dare I say elevates — the investment class from the working

class. So, to the investor, nothing is more important than preservation of capital. Lose your capital (aka principal) and you lose your ability to invest. If you are considering an investment that could result in a total loss of your capital (i.e., the amount you invest), it's not an investment.

Margin of Safety. Investments that could result in total loss are not investments, they are gambles, and the only way to avoid the possibility of total loss is the concept of "margin of safety." How is margin of safety assessed? By a reasoned and objective assessment of the facts. One must ask, "What is the worst-case scenario and, in that scenario, what is my return on investment?" For investments in businesses, whether the investment is in the form of debt or equity, one looks to:

- Historical and projected cash flow in good times and bad
- The certainty to which cash flow — in the worst-case scenario — will be able to meet all obligations, including, of course, operating costs and fixed obligations such as rent and debt service
- Tangible asset values relative to debt (aka debt-to-equity or leverage)

Return on Investment. Investment is an activity engaged in to gain a return on investment, that is, a return of the capital deployed (i.e., the dollars invested, commonly referred to as the "principal") PLUS a risk-adjusted return on investment. Of course, one will at times lose some principal on an investment, but this should be a worst-case scenario and, if five or ten investments are made, the overall return should be very positive (see "diversification" below).

Return of Investment. An investment — even a risky investment — should at the very least provide a return OF your

continued on next page

A Fool and His Money Are Soon Parted (Investing vs. Gambling), continued from previous page

investment. That is, a return of your principal. Again, to the investor, capital preservation is paramount. One might be willing to accept some uncertainty as to the return ON investment, but a return OF investment (i.e., a return to you of the money you invested) should be virtually assured except in cases such as venture investment where diversification is used in a manner that allows losses on investments to be recouped by sizeable gains on others.

Diversification. An absolutely fundamental and essential principle of sound investment strategy is that of diversification. Diversification, at its most basic, is a means for protecting against random risk. That is, risk of loss due to events that cannot be predicted or foreseen. Events such as these DO occur, and the only protection against them is the old adage “don’t put all your eggs in one basket.”

Time Horizon. Games of chance tend to play out in very short time horizons. When you place your bet on a craps table or on a ball game, you learn your fate almost immediately. Investing, in contrast, involves longer time horizons, typically years. Returns may not be realized until many years after the investment is made, but the rate of return is calculated, or assessed, in average annual rates of return. The Internal Rate of Return (IRR) calculation is most common.

Time Value of Money. Because investment returns are often distributed over many years, and because a dollar today is worth more than a dollar tomorrow, the investor will require much higher rates of return on investments that have a longer time horizon. Inherent in the concept of time value of money is:

- Need for inflation-adjusted return on investment
- Uncertainty rises considerably as returns are projected further into the future

So investors want to secure a return OF their investment (i.e., their principal, the

investor’s highest priority) within as short a time as possible. Similarly, investors place a higher value on investments they expect will provide a return on investment over a shorter time horizon.

Optimism vs. Arithmetic. The decision whether to enter into a particular investment should be based on arithmetic, not optimism, hope or blind faith. If your decision about whether to accept a proposition is based on whether others are doing it, run away. Any decision to invest should be founded on a fact-based investigation and whether, all things considered, you can reasonably expect both a return OF your investment and a return ON your investment that fully compensates you for the risk.

Risk and Required Rate of Return. Any investment analysis includes an assessment of expected return in relation to degree of risk. Riskiness can be defined as variability in expected returns. Again, investments, by their nature, have variability as to return but should not also contain uncertainty as to whether a return will be earned at all. Also, as risk or unpredictability levels rise, the investor should demand higher returns to compensate. In short, very safe investments (i.e., investments in government securities or in debt instruments of financially healthy “blue chip” public corporations) should reliably return annual rates that exceed the rate of inflation by at least a few percentage points. On the other end of the risk spectrum, equity investments in new business ventures should provide annual returns in excess of (and, often, well in excess of) 25 percentage points above the projected rates of inflation.

Investment Performance in Difficult Economic Times. Many poor investment decisions are made during times of broad economic prosperity. When the economy or industry has expanded for four or five years in a row, many businesses and/or investments show promising track records of performance. The wise investor takes care not to assume that good times will

continue indefinitely. You must assess how the investment will perform during difficult times, most likely right after you place your bet.

Guilty Until Proven Innocent.

Investing is not about fairness. It’s not about compassion. It’s not about pleasing people. It’s about earning a cold-hearted return on investment. It’s about the dead-serious business of ending up with more cash than you started with. If a reasoned and objective assessment of the facts cannot be used and lead to the logical conclusion that a fair risk-adjusted return will be earned, then the proposition cannot be deemed an investment, at least not a suitable one.

Thomas Tusser wrote that “a fool and his money are soon parted,” and every investor should keep this in mind at all times. Every investor’s perennial ambition should be to prove he is no fool. Benjamin Graham and Warren Buffett, widely accepted as the greatest investors of the past 100 years, both assert that it is not hard to succeed at investing and earn healthy returns over the long run; one need only adhere to sound investment principles. The litmus test is the issue of hope vs. rational expectation based on sound assessment of facts. If you find yourself including elements of “hope” or “excitement” in your decision whether to put your money into a proposition, you’re not investing, you’re gambling.

The following provided meaningful guidance for this article:

Graham and Dodd’s Security Analysis, Fifth Edition, authors Sidney Cottle, Roger F. Murray and Frank E. Block, 1988, McGraw-Hill

The Intelligent Investor, Benjamin Graham, *Fourth Revised Edition*, 1973, Harper Business

The Warren Buffett Way, Robert G. Hangstrom, Jr., 1995, John Wiley & Sons, Inc. □

Buying a Business: Stock Purchase vs. Asset Purchase?

You can buy a business in one of two ways: asset purchase or stock purchase.

In **asset purchase**, the buyer purchases “the business” by purchasing every single asset used by, necessary for or “making up” the business. By doing so, the buyer ends up in effect owning the entire going concern. A business, after all, is simply a bunch of assets brought together and used by the owner and employees to produce goods and/or services.

Business purchases effected by stock can be more challenging for the buyer from a liability containment standpoint.

Purchased assets often include desks, computers, pencils, calculators, staplers, tools, equipment, furniture, fixtures, cars, trucks, inventory, etc., including the rights to software, customer lists, accounting packages, vendor lists, web domains, websites, trade names, logos, marketing materials, phone numbers, etc. The purchased assets are listed in the purchase agreement, as are any excluded assets (i.e., listed as “excluded assets”), and most buyers will include in the purchase agreement language that explains that the purchased assets can be broadly defined as all of the assets of XYZ business (less any asset that is expressly excluded).

Of course, the buyer will also need to make arrangements to secure the employment of any employees he/she may want to continue to work in the business. This is not difficult to accomplish. Similarly, whether the facilities are leased or owned, the buyer needs to reach an agreement, or agreements, to secure use of the facility — assuming the buyer does not intend to immediately relocate it. Furthermore, to the extent there are other important agreements or contracts that the buyer wants to continue to enjoy or work under, such will need to be provided for — whether by assumption, transfer or negotiation and execution of entirely new agreements. Common items are phone service, utilities, sale representative agreements, supply agreements and credit agreements.

In **stock purchase**, the mechanics are much easier. The buyer simply buys the stock (or LLC units or S-corp shares, whichever is the case) of the legal entity that owns all of the business assets. This, of course, assumes the business is in fact held in — or owned by or within — a legal entity (i.e., is not a sole proprietorship).

Stock purchase virtually eliminates the need to transfer title (i.e., purchase) to all of the many different assets used in or by the business. It also can eliminate the need to transfer, renegotiate or reapply for things such as permits, utilities, facilities leases and employment agreements. Of course, some contracts may have so-called “change of control” provisions that will require special attention.

Liability Considerations. Business purchases effected by stock can be more challenging for the buyer from a liability containment standpoint. It can be more difficult for the buyer to avoid assumption of unwanted, or unknown, liabilities of the purchased business. For this reason, stock purchase transactions can be riskier and also require higher levels of due diligence.

Tax matters. Taxes are a major consideration in business purchase transactions. This is because taxes cost real money and impact cash flow and rates of return. Business purchases effected by the asset method almost always provide for lower taxes for the buyer going forward. This is because the asset purchase allows for a step-up in the tax basis of the assets and, in turn, generates depreciation deductions. Business sellers, on the other hand, typically have to pay higher taxes on asset sale transactions, so these issues become points of negotiation — even contention — between buyer and seller.

Of course, virtually any liability may be transferred back to (or retained by) the seller by contract (i.e., in the purchase agreement), so just because a purchase is effected by stock does not mean that all pre-purchase liabilities will be borne by the buyer, but it would require considerable seller cooperation and skilled crafting of the definitive agreement.

IRC Section 338 Election. Although there can be some advantages (mainly ease of title transfer) to the business buyer who effects a purchase by stock, most prefer the asset method for the reasons mentioned above (liability containment and tax advantages). Similarly, in some unique instances, the seller is indifferent as to method, but most often the seller prefers a sale by stock (for tax reasons).

Sometimes in these situations, Internal Revenue Code (IRC) Section 338 is useful. This federal tax law allows parties to elect a stock-method business transfer taxed as if it were an asset purchase. The trick is the buyer has to pay the tax bill that arises from the step-up on the basis of assets, which occurs under asset purchase transactions (or, of course, stock purchase transactions taxed as asset transaction by an IRC Section 338 election).

Why would a buyer agree to this and also take on the stock sale liability issues? Well, only if he, she or it has incentive to do so. For one, the buyer would have to get comfortable with the liability issue. Two, the buyer would have to feel okay about the tax bill. Such can occur if or when the seller provides the buyer with incentive to do so, for example, a reduced purchase price. The tax bill issue also can “go away” in instances where either the purchased entity or the purchasing entity has tax losses that can be used to shelter the gains.

Buying a business is a very serious, complex matter. Seek the advice of legal, tax, and merger & acquisition experts such as Acquisition Advisors (www.AcquisitionAdvisors.com). □

Have a “Most Trusted”? An “Incredibly Loyal”? Watch Out!

Scams hide behind smiling faces. These are the words of Phil Mulkins, *Tulsa World* newspaper *Action Line* writer, in response to a question about how one might keep oneself from being stung by fraud.

“People who think they can spot investment scams can’t because they’re suckers for smiling faces,” says the Council of Better Business Bureaus website (according to Mr. Mulkins). “They look professional and appear successful,” it continues.

To be sure, fraud is prevalent. According to the Association of Certified Fraud Examiners (ACFE), U.S. organizations lose 5% of their annual revenues to fraud. Applied to the United States Gross Domestic Product, this 5% figure would translate to approximately \$700 billion in fraud losses. Small businesses suffer disproportionate fraud losses. The median loss suffered by organizations with fewer than 100 employees was almost \$200,000 per scheme, and most involve the accounting department or upper management.

Research also shows that when fraud is perpetrated by employee on employer, it’s typically carried out by the employee who is most trusted. The golden boy. Your closest confidante.

From what I’ve read and what I’ve painfully experienced, fraud — when it occurs in a single event — is made possible, in part, with pressure, stress or emotion. A skilled fraudster finds a way to bring these elements to bear on the victim, usually the person who must provide approval, access or authorization. Or the fraudster waits patiently and strikes when outside forces rise up and conveniently apply pressure, stress or emotion.

In the case of investment scams, a la Bernie Madoff (United States) or Pacific Continental Securities (United Kingdom), it might be a hot stock tip that must be seized on right away. It’s “come on, you want to get off the sidelines and make some big money, right? Here’s your chance. Let’s take down \$50,000 and make a quick \$100K.”

In the case of fraud in the workplace, it might be that you are under considerable time pressure and stress from unrelated matters, and the perpetrator presents you with the resolution to the problems that you have been having in your relationship with him/her. “I really want to get this resolved now. Do me a favor and just sign this. It’s not perfect and I know it’s deficient in these areas, but trust me. We’ll work the rest out later.”

In short, watch out for:

- Manipulation.
- “I’m insulted.”
- High emotion.
- Territorialism.
- “Do we really need these formalities?”
- “Don’t you trust me?”
- “Just let me handle it!”
- Unreasonable or irrational claims of “it can’t be done that way.”

Watch out when you feel yourself really needing, or wanting, to accommodate someone. Watch out when you feel yourself really wanting to make another person feel that you trust him/her or feel that you approve of his/her efforts. Finally, watch out when you find yourself listening to the assurances of others rather than the voice inside your own head that’s saying “this smells funny!”

Trust your gut instinct. If you feel pressure or uncertainty, back away! □

About the Publisher



David L. Perkins, Jr. owns, writes and publishes *The Business Owner Journal*, the newsletter of

choice for more than 25,000 business owners who are serious about building wealth through successful private business ownership.

Perkins draws editorial ideas and inspiration from his own life as a business owner and investor, and his daily work as a mergers & acquisitions consultant, where he has advised on more than 100 purchase/sale transactions involving both private and public companies. His M&A consulting firm is Acquisition Advisors, which he founded in 1997 and which specializes in transactions valued between \$5 million and \$75 million. Visit AcquisitionAdvisors.com to learn more.

Perkins holds a bachelor of arts degree in psychology from the University of Oklahoma and an MBA from the University of Notre Dame, and has completed the executive education course titled “Mergers and Acquisitions” at The Wharton School, University of Pennsylvania. He also pulls editorially from prior experience in commercial real estate leasing and brokerage, commercial bank lending and private company financial management.

Perkins is the author of *A Concise Overview of Business Valuation* and co-author of *The Business Sale, An Owner’s Most Perilous Expedition*. You can buy the former at www.TheBusinessOwner.com.

Contact him at 800-634-0605 or DPerkins@DLPerkins.com.

Reconciling Value with “Offer for Purchase”

An offer for purchase says almost nothing about the value of a business. Why? Because “value” (as in market value) is the price a buyer is willing AND ABLE to pay. An offer, by its very nature, does not say much about ABILITY to pay. Heck, it may not even say much about actual willingness! You know, it’s easy and ego-stroking to throw around big money and big plans, for investors or company managers to talk about buying another business.

I see MANY business owners get confused about this issue of value as it relates to “offers.”

There is also a rather unscrupulous business-buying strategy used in the marketplace whereby the buyer offers a high price (i.e., one the buyer would never actually pay) to get the seller prospect to the table and to begin working long and hard on the deal. Key to the strategy is to get the seller to feel so close to retirement — to the good life — that he/she can taste it! Even better is if the seller tells his/her friends and family (and those who are prone to fall prey to scams like these often will!) or makes a big asset purchase (vacation home, boat, etc.). Then, late in the game, the price gets reduced. Some sellers will be unable to swallow their pride and “go all the way back to their former life.” So, after a big fight, they just accept the lower price.

I see MANY business owners get confused about this issue of value as it relates to “offers.” They get a big offer — often just a verbal — from someone, and they accept it as “what the business is worth.” Then, when they want to sell, they waste countless amounts of time, money and credibility trying to get this number. Or they place this value in their estate plan and — garbage in, garbage out. The day of reckoning will come.

This issue also comes into play when a business owner who is selling out receives multiple offers. What should he/she do, just accept the highest-priced offer? Well, if your time has little value to you, you’d feel just fine about simply taking the highest offer. But if you DO value your time or have a date certain by which you may want to close a transaction, “ability to pay” becomes an all-important consideration.

More food for thought? Consider the business seller who was offered \$4 million all cash for his business and, in the end, the buyer was unable to get the deal done. What is the business worth? Is it worth \$4 million? □

An offer, by its very nature, does not say much about ABILITY to pay.

Q&A: Does Your Business Indemnify You from Personal Liability?

Question: A business owner I know recently was threatened with legal action by one of his minority stockholders for excessive compensation and for the personal use of an expensive company car. I own 80% of my company; three people own the other 20%. How can I protect myself against such a lawsuit?

Answer: Whenever there are minority owners, you have potential problems. As the principal owner and decision maker in your company, conflicts of interest can arise on whose interests you best serve — yours or the corporation’s. As a board member, you are supposed to watch out for the interests of all owners, not your own. The best ways to protect yourself from conflict-of-interest claims are:

- Refrain from voting on any company matter that personally affects you. For example, allow your other board members to approve your compensation, benefits, etc.
- Deal with your business on an arm’s-length basis, that is, as if you were dealing with an independent, unrelated person. Don’t treat the business as if it were your personal source of money, benefits, etc.

To protect yourself, put an indemnification clause in your company’s bylaws. You might also consider buying indemnification insurance. □



“Do me a favor and call Tom. It looks like Jerry is on to something.”

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Eight Ways to Maximize Your Odds of Getting Paid

- 1. Get Your Agreements in Writing.** Oral contracts leave lots of room for misunderstanding and tend to change when the going gets tough.
- 2. Use Standard, Widely Accepted Form Contracts:** If you do so, not only do you save money on drafting but courts of law tend not to dispute their fairness. Further, courts interpret contracts against the writer, so if you don't write the agreement (i.e., you obtained it from a third party, such as your trade association), you've eliminated this risk.
- 3. Penalties for Late Payment.** Such stipulations, agreed to by the opposing party, provide incentive for on-time payment. It also reinforces to any and all that payments are (or were) intended to be paid on time as agreed.
- 4. Escrow and/or Collateral.** If the amount of the contract is substantial, consider mitigating your risk by requiring escrow funds (can be deposited with an escrow agent or law firm) or collateral (an asset that creditors agree to allow you to have if they don't pay).
- 5. Deposit or Progress Payments.** If the amounts are sizeable and/or the creditworthiness and character of the other party are unproven or questionable, consider requiring a deposit/down payment and/or require progress payments as you incur cost and/or fulfill your end of the bargain.
- 6. Promissory Note.** Financial obligations memorialized in a promissory note have considerable advantages. If the amount is sizeable, get a promissory note signed in addition to the main agreement.
- 7. Arbitration Clause.** Arbitration can be a swifter, thriftier way to resolve disputes. Consider including an arbitration clause in your agreements.
- 8. Small Claims Court.** Most states provide this low-cost way to pursue legal collection of judgments in disputes involving less than \$10,000. If you have such an amount in dispute, look into small claims court.

Of course, talk to your attorney before implementing any of these suggestions. ☐

CASH FLOW

Harvest Cash by Reducing Inventory

If your business is one that requires inventory, you almost certainly have dollars trapped in part numbers that are not moving. During slow times, get in there and figure out what's not selling. Then hold a sale, run some specials or do whatever you can to release that much-needed cash. You know? You paid for it a long time ago. If it's not going to sell anytime soon at regular prices, so why not take 25 or 50 cents on the dollar today? ☐



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