

Cost Drivers and Where to Look to Lower Cost

Every customer is price sensitive. Price is a key characteristic of your offering, whether your business strategy is to offer value through low prices or superior quality at a premium price. If you price your goods too high, the customer may purchase elsewhere.

For this reason, every business is under immense pressure to lower prices, especially during economic downturns when every company is competing harder to win fewer orders. Struggling companies may even be willing to accept business at break-even prices ... just to cover fixed overhead.

The only way to survive and profit is to continually lower the cost that it takes you to produce and deliver each unit. The marketplace largely dictates the price that buyers will accept. The only thing we control, besides our product or service itself, is our own cost structure. And, we have much more control over our own costs than most business owners realize.

This article presents key drivers of cost. Each "driver" describes an area in which costs arise and can be reduced. Costs are described in terms of "value activities," which are the many discrete activities a business performs in designing, producing, marketing, delivering and supporting its products or services. Take time to understand each cost driver, and then consider how each may be contributing to costs incurred within your business. Better yet, find ways to lower costs associated with each driver.

Cost Driver #1: Economies of Scale

Economies of scale arise from the ability to perform activities differently and more efficiently at larger volume, or the ability to amortize the cost of things over a greater sales volume. An example of the former might be a roofing contractor that focuses on obtaining a higher concentration of jobs in a small geographic area to allow for reduced drive times and more efficient sharing of personnel and equipment between jobs.

Economies of scale can be found to some extent in most any part of a business' operations, including purchasing, processing, advertising, sales, marketing, billing and collection. Scale economies can be achieved by increasing total sales or by restructuring a product line to offer fewer choices and therefore more volume per product offered.

Given the economies that volume or scale can provide, businesses should organize themselves in a way that allows for volume processing. The first place to look is where natural advantage over competitors may be. For example, a printing company that has a piece of equipment that allows for more efficient processing of a certain type of job might attempt to increase the amount of business they do of this type.

The rate of learning in an organization tends to be dependent on the degree to which management emphasizes the importance of it and empowers workers to conceive, investigate and implement process improvements that reduce cost, improve efficiency or add value to products or services.

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From The Editor

Greetings business owner, and welcome to the May/June 2003 issue of *The Business Owner*. This issue begins with an in-depth article on the broader elements that drive costs in a business. All of us, as owners of private businesses, have become skilled at “being cheap” and watching our dollars. But there likely are a bevy of ways in which we could lower our costs by taking some time to better understand how costs are driven by processes, linkages, and other “cost drivers” within our company.

By restructuring things like layout, location, and how our suppliers provide their goods and how our goods are sold, we might be able to significantly lower the labor hours required, materials used, or other costs. I urge you to resist the temptation to dismiss this topic intuitively with “my costs are already as low as they can go”, but spend time with the article and think about your business. Have your key personnel read the article as well and then discuss with them ideas for simplifying your business in a way that could yield cost reduction. It is likely that the quality of your product or service could be improved in the process.



David L. Perkins, Jr.

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Publisher and Editor

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STRATEGY/PROFIT MAXIMIZATION

Continued from cover

It is naturally positioned to win this type of business over its competitors, and higher volumes will allow the cost of the machine to be amortized over larger volumes, thereby enabling higher profit per job.

Cost Driver #2: Learning

The cost of an activity can decline over time due to learning that increases efficiency. Learning can provide ideas for reducing costs through such changes as floor layout, improved scheduling, labor efficiency improvement, product design modifications, yield improvements, or improvements in installation and shipping procedures. Performance improvements derived from learning typically accrue gradually and incremental over time.

The rate of learning in an organization tends to be dependent on the degree to which management emphasizes its importance and empowers workers to conceive, investigate and implement process improvements that reduce cost, improve efficiency or add value to products or services. The rate of learning can be greater during times of light workload as it is during these times that additional time and energy may be focused on process improvement and idea generation.

Vital learning also can occur from one firm to another through the movement of employees or through facilitators such as trade organizations or schools. Every company should take advantage of these. But, since a sustainable cost advantage results only from proprietary learning (learning that is not possessed by your competitors), some care should be taken to protect your proprietary learning from being transferred to your competitors. This can be done by limiting turnover of personnel and taking steps to protect the dissemination of information that is proprietary to your company (see “Trade Secrets” article in this issue).

Cost Driver #3: Capacity Utilization

When a value activity has a large fixed cost associated with it, the cost of the activity will be affected by capacity utilization. For example, a school supply retailer has high fixed costs associated with its physical “store.” But it can handle a very large volume range with minimal increases in cost. As sales rise, the fixed cost of the space and staff are amortized over a larger sales volume, thereby enabling higher profit.

Fixed costs also create a penalty for underutilization, and the ratio of fixed costs to variable costs determines the sensitivity of a value activity to utilization. For example, a firm that uses independent reps to sell their goods reduces sensitivity to capacity utilization compared to an in-house sales force. This is because when reps are paid only when they sell (commission), they don’t contribute to fixed overhead as a salaried salesperson would. Of course, the incremental profit on sales by reps is typically lower, but fixed overhead is less.

The pattern of utilization is also a key factor. It is smooth volume at optimal utilization that is desired. We all know that operating at low capacity is inefficient, but operating at or near capacity can cause inefficiencies and higher costs as well. Company policies and practices should be designed to produce smooth demand and work flow. For example, heat and air conditioning contractors often provide incentives to entice customers to contract for repairs and maintenance at times of the year that tend to have lower service call volumes.

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Buy-Sell Agreements

If you have partners or co-owners, you need to consider what will occur when a partner wants to retire, or suffers death or disability. If not planned for properly, such events could create chaos in the business and financial hardship for all those that depend on the business' stability and profitability.

One way to control the order of events following the retirement, death or disability of an owner or partner is to design and execute a buy-sell agreement. The major reasons to effect a buy-sell agreement are to:

1. *Preserve control* by restricting transfers or sales of company stock or other ownership interests to persons outside the company or outside the owner's immediate family.
2. *Protect the business' assets and its ongoing operations* in the event of death, retirement or disability of an owner.
3. *Provide cash or other assets* (e.g., life insurance proceeds or promissory notes) to the retiring or disabled owner, or the family of the deceased.
4. *Establish a method for determining the value of the business* for estate tax purposes and for setting a fair price for the future transfer or sale of company stock.
5. *Assure sufficient liquid assets* are available to fund a buyout, federal and state estate taxes, and to meet the financial needs of surviving family members.
6. *Structure stock incentive awards* to retain key employees, who also can be part of the buy-sell arrangement.

Structuring a Buy-Sell Agreement

A buy-sell agreement protects business value and assures the continuation of a business beyond its current owners. Properly structured, a buy-sell will also provide income to the retiring or disabled partner, or to the family of the deceased partner. The initial questions that need to be considered are:

- Should the buy-sell be a cross-purchase or stock redemption?
- Should the buy-sell be funded with the proceeds from life insurance on each owner's life and what cautions should the surviving owners take to assure payment?
- If insurance is the financing vehicle, should the premiums be paid by the company or

the individuals?

- How can you structure insurance policies to reduce or eliminate income and estate taxes?
- How will the business, or partial ownership interests in the business, be valued under the buy-sell agreement ... and will it conform to IRS valuation guidelines?
- Is the valuation method dynamic so that the valuation of the business changes as the business changes?
- Will changes in the business value trigger adjustments to the mechanisms that will provide buy-out funds?

There are two principal methods to effect a buy-sell agreement:

1. *Cross-Purchase* - When existing stockholders or partners purchase each other's ownership interest, and
2. *Stock Redemption* - When the business purchases the stock of shareholders or partners.

In some cases, a combination of both buy-sell methods is used.

Buy-Sell Agreement Checklist

Here are the major items to include in a buy-sell agreement.

- Names of the individuals, number of shares (percent ownership), purchase price, and the corporate or partnership entity involved in the buy-sell arrangement.
- When the agreement will become effective: death, termination of employment, retirement and/or disability.
- Method of stock purchase: stock redemption, cross-purchase, a combination of both, or a *survivor's option* plan where the decision is not made until the death or retirement of the owner.
- Buy-sell value (price) and the method for updating the value over time, preferably every year or two. Keep in mind that the value of many closely held businesses can increase (or decrease) substantially from year to year.
- How the owner(s) will be paid for the stock: life insurance proceeds, promissory notes, other owners' personal assets, company cash or a combination.

- The circumstances under which the ownership position (e.g., actual shares of common stock) can be hypothecated or otherwise encumbered for loans or other purposes.
- Whether the buy-sell is a legal *obligation* or only an *option* to buy or sell.
- Conditions under which the buy-sell is to be amended or terminated – the written approval of all or just a majority of those involved.
- State law governing the agreement and any arbitration provisions in case of a dispute.
- A “first-offer” or “right of first refusal” clause that states that, before a stockholder can sell his or her stock to another individual (or firm), it must first be offered to the corporation and/or to other stockholders at a predetermined price.
- A clause binding *future* owners to the buy-sell agreement, e.g., covering stock options issued to key executives and other employees.
- A provision for an independent trustee if the purchase price of the shares is substantial and funded by life insurance. *Recommendation:* Use a law firm or financial institution to make sure the insurance proceeds are disbursed *directly* to your designated heirs/beneficiaries.

Valuation Methods to Use in Buy-Sell Agreements

Be aware that the IRS can challenge the value placed on the business in the buy-sell agreement. This occurs most often when no documentation exists to support the business' value and price per share. Documentation is particularly important if the buy-out is substantial. You can support your valuation and buy-sell price by using one or more of the following accepted valuation methods.

- *Book Value:* This value is prepared by your accountant and is simply the company's total assets less all liabilities. *Tangible net book value* could also be used, which excludes all intangible assets such as capitalized financing costs and goodwill.
- *Adjusted Book Value:* This method amends the company's book value to reflect any difference between reported book value and the actual fair market value of the

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Buy-Sell Agreements, continued from previous page

assets and liabilities. For example, the book values of many depreciable assets, such as equipment and buildings, are often understated on the balance sheet. The adjusted book value method usually renders a value higher than reported book value.

- **Replacement Value:** This method calls for the adjustment of all assets to their replacement value and then the subtraction of all liabilities. This method usually leads to a valuation that exceeds that of book value and adjusted book value, and can yield a higher value when selling to another company that wants to get into your line of business.
- **Price-Earnings Multiple (P/E):** The partners must agree on a somewhat arbitrary multiple to apply to earnings and thereby calculate a value for the business. For example, if the multiple of seven is selected and the company has net income of \$100,000, the value of the company is \$700,000. A reasonable range for P/E of a small or mid-size private company is 5 to 10. Companies that are growing rapidly should have higher multiples than slow or no-growth firms.
- **Earnings Before Interest and Taxes:** Referred to as EBIT, this method is similar to the P/E method described above but uses an earnings stream that is before interest and taxes. For this reason, EBIT will always be a larger number than net income. A reasonable EBIT multiple for a small or mid-size private company is 2 to 6. Higher growth rates will merit higher multiples, as will stability of earnings, larger size, healthy profit margins, management depth and other factors.

Your accountant can help you apply the above valuation methods. You might also consider using two or three of the above, and take an average or apply weights to each. Doing so will yield a more reasonable number as asset-based valuation methods can often yield results that differ greatly from earnings-based methods.

Additional Considerations for Your Buy-Sell Agreement

There are other precautions you should take to assure the buy-sell agreement's validity and effectiveness. Again, these ideas apply to *both* existing and new buy-sell agreements.

1. To protect your right to acquire the shares, each ownership certificate subject to a buy-sell agreement should have a *written legend* stating such on the face of the certificate.
Ex. "These shares are subject to a buy-sell agreement dated _____."
2. The signed buy-sell agreement must be bona fide, entered into in good faith, and effected on an arm's-length basis ... particularly when transacting with family members. (You can't set a low value on a small portion of your company stock and expect that value to apply to your remaining holdings for estate tax purposes.)
3. The buy-sell price per share must be reasonable and legally binding. It cannot be a device to transfer ownership to family members at less than its *full* fair market value.
4. The owner or his or her estate must be restricted from selling the shares without first offering it at the buy-sell agreement price to the other stockholders or to the company.
5. **Disability Buy-Out:** When reviewing this report with your advisers, also discuss how to protect yourself if you or another owner becomes disabled.
6. **Installment Sale:** To defer taxes, you also might want to consider an installment sale of the ownership interest. However, keep in mind that delaying receipt of payments to your beneficiaries or heirs also increases the risk of non-collection.
7. **Stock Redemption:** Be careful if the corporation is buying the stock; you will have to provide for that in the corporate minutes and obtain other stockholders' approval.
8. **Use More Than One Adviser:** Effecting or updating a buy-sell agreement can be complex. Be sure to obtain the advice of your accountant, lawyer, insurance agent and estate planner.

Financing the Buy-Out of Your Stock

Establishing the procedure by which stock is bought and sold on the departure or death of a company owner is the first step in protecting the company. Providing the money to carry out the procedure is the second.

You can't assume that the surviving owners will have enough personal liquidity to finance the purchase on their own or that they will be eligible to borrow the required amount. The price tag on shares in a profitable, growing company can be substantial. Nor can you assume the company will have sufficient liquidity or access to capital to fund the purchase on its own. You might want to consider another approach for providing the needed money.

Consider life insurance. Life insurance on the life of each owner can supply all or part of the needed cash. If the corporation sets up a stock redemption plan, it buys the insurance and names itself as the policy's owner and beneficiary. Although this method does provide the required cash, be careful. The actual buy-out will usually increase the stock's value for the remaining owners, especially if the buy-sell uses a book value formula.

Example of Increased Value:

Assume three stockholders each own one-third of a corporation. When one dies and the corporation buys his or her interest, the remaining two stockholders will each own 50 percent. Consequently, the value of their ownership position substantially increases, which can correspondingly increase their potential estate taxes and the need for more life insurance on each remaining owner's life.

When the owners are responsible for the buy-out, each may insure the life of the other. The

insurance payout is then used to purchase the deceased owner's interest. Inexpensive term insurance can be used, but make sure it can be converted to permanent (whole life) insurance.

Also, watch out for situations where the company ends up assuming the obligations of the remaining owners who are forced to buy the stock of a departing or deceased stockholder. If the company satisfies the

If your business is the owner and beneficiary of a life insurance policy underlying a stock redemption plan, do not deduct the premiums from your taxable income. If you do, the IRS will almost certainly tax the policy proceeds, when paid.

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OWNERSHIP

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personal obligations of the remaining stockholders, there could be serious tax consequences, e.g., the IRS could label the payments as dividends to the surviving shareholders. That's why expert tax and insurance advice is always needed before structuring and finalizing a buy-sell agreement.

How much insurance to buy. The shares to be covered by insurance on each owner's life represent a certain percentage of the company's value at the time the insurance purchase is made. For example, if there are four stockholders who each own 25 percent of a company valued at \$1.2 million, then \$300,000 life insurance must be purchased on each owner's life. To reflect *future* increases in the value of the stock, the dollar amount needed to purchase the shares should be adjusted periodically along with the amount of life insurance being relied upon to finance the purchase.

Joint life or first death. Another possibility, where several owners have roughly equal shares of the company, is *joint life* or *first death* insurance. The policy covers all of the owners, but pays the life insurance proceeds only when *any one of the group* dies. The insurance proceeds can be paid to the company or to the others in the group,

depending on how the agreement is set up. Of course, if this type of insurance is used, it will be necessary to work out a new arrangement and take out a new policy after the death of one of the owners.

Covering a shortfall. Regardless of which buy-sell method is used, provisions should be made to make up any shortfall in the life insurance proceeds. For example, if only \$200,000 insurance is available to buy, say, \$300,000 of stock, then \$100,000 additional cash should be provided for. The agreement can specify that such a shortfall be covered by an installment note payable over three to five years. In addition, provision should be made for the use of any *excess* proceeds if the amount of life insurance exceeds the buy-out price.

Buy-Sell Taxation

If a buy-sell agreement is funded with insurance, it is critical that such is structured in a manner that minimizes taxes. Here are the most significant tax-related questions:

- (a) Who pays the premiums and are they tax deductible?
- (b) Will the life insurance proceeds be tax-free or taxable income?
- (c) Who owns the policy and who is the beneficiary?

Generally, life insurance premiums are *not* tax deductible and life insurance proceeds are *not* taxable income when received by the beneficiary. If the company is the owner and beneficiary of the life insurance policy underlying a stock redemption plan, there is usually no taxation. It's straightforward – the premiums *are not* tax deductible by the company, so the proceeds received *are not* taxable income.

Problems can occur when the company is not listed as the policy owner, rather the company owner is. When the company owner dies and the company uses the insurance proceeds to acquire the stock from the deceased owner's estate or heirs, the proceeds will be included in the value of the estate of the deceased. This could trigger significant and unnecessary estate taxes.

Estate taxation has gotten increasingly complicated in recent years. Talk to your tax attorney and financial advisor about the proper structure of your buy-sell agreement and related insurance policies. □

"You must deserve victory."

Winston Churchill

SCAM ALERT

\$cam Alert: Living Trusts

Ignorance breeds fear and fraud; and high-pressure salesmen, Web sites and telemarketers are preying on older persons who fear losing their life savings to so called "death taxes." The debate in Congress over eliminating the estate tax is adding fuel to the fire.

Often these scammers promote living trusts, but living trusts are almost never appropriate for lower or middle-income persons who have small estates. Unless an estate exceeds \$1 million, there is no federal "death tax" and thus no need to be concerned with taxes eating up a major portion of a bequest to loved ones.

Last year, the AARP – the advocacy organization for older persons – found a 125 percent increase in the number of people 50 years and older with annual incomes under \$25,000 who own living trusts. AARP was outraged to learn that some of those peddling the plans have said they were endorsed by AARP. In fact, the AARP reports that it does not endorse any company that sells living trusts.



Living trusts, also called irrevocable trusts, are a valid tool for more affluent individuals, including those who have small businesses or real estate. In fact, not only are trusts not needed by most people, they are expensive and can cause major problems for those who enter into them without competent

legal and financial advice from an attorney and experienced financial planner.

If your estate (personal assets) is upwards of \$2 million or more, talk to a trusted and experienced financial planner or tax attorney. And, know that moving assets into a trust can result in severe penalties if an individual applies for Medicaid within five years of establishing the trust. In addition, if a personal residence is placed in a trust, it is no longer exempt from the estate tax, thus completely negating the reason for establishing the trust in the first place. □

Can a Family-Business Work for Both Family and Business?

Family owned businesses make up approximately 80 percent of all businesses in the U.S., and it is estimated they account for 60 percent of the total U.S. output of goods and services (i.e. gross domestic product, referred to as “GDP”). Some are small “mom and pop” organizations while others are multi-generational, multi-billion dollar companies like Ford or Cargill. Taken together, they represent one of the hearthstones of American business and “the American dream.”

Despite playing a major part in our economy and our society, some statistics are discouraging to the many private business owners that long to see their businesses “carried on” by their children and grandchildren. It is estimated that only 30 percent pass to the second generation and only 15 percent to the third. The reasons for these outcomes are varied, but include:

1. The first generation owner was an entrepreneur that developed an innovative product or service. After early success, not enough attention was paid to the need to continually improve and to respond to competition and a changing marketplace.
2. The founder had the energy and passion for the business, but had not transmitted the enthusiasm and emotional ownership to the next generation.
3. Family needs, including “making each family member happy” took precedence over business needs, and – over time – the business became uncompetitive, unfocused, unproductive and undercapitalized.
4. Family members didn’t know how to communicate, confront issues and/or manage conflict. Problems festered and people left or acted out the problems through the business.
5. The business was run like a family ... ad hoc, random, informal and without good business practices.
6. Home and work roles conflicted. People reacted to each other according to their family roles, not business roles.

These challenges, and others, are difficult but not impossible to overcome. Family members must be able to not only work together to make their businesses successful, but promote positive family feelings. Families that succeed in business together share several common characteristics worth noting. For example, they come together as adults and overcome the emotional baggage that sometimes accumulates during the “growing-up” years. They shift away from a “parent-child” way of relating to one another and move to an “adult-adult” orientation. Parents move away from needing to be “in charge,” which allows the family to connect on a more level playing field.

“Families that succeed in business together share several common characteristics worth noting.”



Successful families develop the skills, trust and mutual respect necessary to openly confront and deal with sensitive issues without becoming defensive. Solving difficult and complex business problems requires open communication so the issues can be identified and every potential solution explored. Sometimes these problems are associated with a family member who tends to inhibit candid discussions. Successful families have developed constructive methods of handling the most difficult topics.

Families that are successful in business together work on effective interpersonal boundaries and are aware of the limitations of influencing anyone else’s behavior. They don’t try to “fix” others. They realize you cannot control other people and events; you can only control your reaction to them. For example, parents must realize they can offer counsel and support, but must ultimately leave it up to others to make choices and experience the consequences.

Flourishing families recognize when a conflict is escalating and have ways of making sure a situation doesn’t spin out of control. All too often, conflicts escalate as events are misinterpreted and responses are given in the heat of the moment. These types of responses are hard to take back and overcome. Ultimatums are dangerous. Successful families are able to circumvent such situations to avoid long-term damage to the family and the business.

Most importantly, these families value and commit resources to spending time together, celebrating the family and nurturing the relationships that bind them together. Family gatherings receive a high priority. Setting time aside to reconnect, have fun and just enjoy each other’s company are of utmost importance.

Together, these factors all combine to keep a family positively connected through time, and able to thrive through the difficulties and perils they are sure to encounter. And, to be fair, few families manage to practice these things every time. Nevertheless, successful families have a special compass that keeps them headed in the right direction and brings them back on course when things get off track. □

This article was provided by the Aspen Family Business Group (AFBG), which will periodically contribute articles. Additional information may be found at www.AspenFamilyBusiness.com, including a description of their annual “Gathering” of family business owners to be held this year in Snowmass July 31st through August 3rd. The gathering is an exceptional opportunity to learn how to optimize the health of your family business.

Military Leave: Reemployment Rights & Obligations

If you own or manage a business, it is time to acquaint yourself with the Uniformed Services Employment and Reemployment Rights Act ("USERRA"), 38 U.S.C. §§4301-4333. USERRA was enacted by Congress and signed into law by President Clinton on October 13, 1994. Congress amended the law in 1996, 1998 and 2000.

All civilian employers, whether private or public and regardless of size, must comply with USERRA. USERRA provides for military leaves of absence; regulates what rights these workers have to health insurance, pension plans, and other benefits; and provides for reemployment of eligible employees when they return from military leave. In addition, USERRA supersedes state laws regulating military leave to the extent that state law limits or conditions reemployment rights or benefits; however, USERRA does not displace state laws that provide greater rights.

Absences to perform any duty, whether voluntary or involuntary, in a "uniformed service" are covered by USERRA, including active duty as well as absences for training, weekend drills, summer camp and fitness for duty examinations. Employees are eligible to take military leave if they or an appropriate military officer gives advance written or oral notice to the employer of the employee's military service. USERRA does not set a specific time for giving advance notice, but employees should make every effort to provide reasonable notice, depending on individual circumstances. No notice is required if doing so is impossible or unreasonable because of military necessity or other legitimate reasons. Written proof of the need to take military leave cannot be required to grant leave. Only if the combined length of an employee's prior military leaves is more than five years may leave be denied. Even if an employer thinks the timing, duration, frequency or nature of the employee's military service is unreasonable, it cannot deny the employee leave from work.

Pay During Leave. USERRA does not require pay during military leave. However, some employers voluntarily pay workers the

difference between their regular wage and military pay received for a period. Some state laws may have additional pay requirements for employees during military duty.

Vacation. USERRA gives employees on military leave the right to use any vacation or similar leave with pay that they accrued before military service. Use of accrued vacation time is at the employee's option. Employers cannot require the use of vacation time while on military leave.

Health Benefits. Employers must provide COBRA-like health benefit continuation coverage for persons who are absent from work to serve in the military, even when the employer, due to its size, is not covered by COBRA. If a worker's health plan coverage would terminate because of an absence due to military service, the employee may elect to continue the health plan coverage for up to 18 months after the absence begins or for the period of service, whichever period is shorter. The employee cannot be required to pay more than 102 percent of the full premium for the coverage. If the military service lasts for 30 or fewer days, the employee cannot be required to pay more than the normal employee share of any premium.

All civilian employers, whether private or public and regardless of size, must comply with USERRA.

Other Benefits. Employees on military leave are entitled to participate in any benefits that are not based on seniority, and that are available to employees having similar seniority, status or pay that are on non-military leaves of absence. Examples of this could include year-end bonuses, insurance and accrual of sick or vacation days, or any other benefit not based on length of employment that is available to other employees on leaves of absence.

Replacement. A big unknown employers must deal with is how long an employee will

be away. Employers faced with employees being called up have to decide whether it makes more sense to temporarily replace them or to see if co-workers can reasonably be expected to carry an increased workload. Employers are free to fill vacancies left by employees on military leave. However, a returning service member is entitled to his or her reemployment position required by USERRA regardless of whether another person occupies it. The returnee must be placed in the required position, even if this results in "bumping" the current employee.

Reemployment. Employees who have taken military leave generally have the right to return to their civilian job without loss of seniority or benefits. The law regarding reemployment rights is lengthy and complex and may require legal advice, but a very general explanation is provided below. Except with respect to persons whose disability occurred in or was aggravated by military service, the position into which an employee is reinstated is determined by priority, based on the length of military service, as follows:

Service of 1 to 90 days: (a) in the job the person would have held had he or she remained continuously employed, so long as the person is qualified for the job or can become qualified after reasonable efforts by the employer, or (b) if the person cannot become qualified, in the position the person was employed on the date of the commencement of the military service.

Service of 91 or more days: (a) same as for service of 1 to 90 days, or a position of like seniority, status and pay, so long as he or she is qualified, or (b) if the person cannot become qualified, in the position the person was employed on the date of the commencement of the military service or which nearly approximates that position. This reflects the "escalator" principle, which requires that a returning service member step back onto the seniority escalator at the point he or she would have occupied if he or she had remained continuously employed.

continued on next page

Continued from previous page

USERRA specifies that returning employees must be "promptly reemployed." What is prompt will depend on individual circumstances. Reinstatement after three years on active duty might require two weeks to allow giving notice to an incumbent who might have to vacate the position.

Time Limits For Reinstatement. Time limits for employees returning to work after annual training or other types of

extended military leave of absence depend on the duration of the orders. A very general explanation is provided below:

Service of 1 to 30 days: The beginning of the first regularly scheduled workday or 8 hours after the end of the military duty, plus reasonable commuting time from the military duty station to home.

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BUSINESS VALUATION BASICS

Time Value of Money, Risk, Discounting and Return on Investment

The valuation of any income generating asset or group of assets, including a business, requires that the investor consider the basic concepts of time value of money, risk, discounting and return on investment. Below is a brief summary of each.

Time Value of Money. Most people would rather receive a dollar today than in the future. As such, most people will pay less for a dollar received in the future compared to one received today. The simple fact that a dollar received today can be deposited into a bank account to earn income supports this concept of *time value of money*.

Risk. The degree of uncertainty of whether expected returns will actually be realized is referred to as the *risk* of an investment. Because no investment is 100 percent certain to provide the expected return, investors discount the anticipated future cash flows by a rate greater than the standard for risk-free investment – U. S. Treasury obligations (the risk free rate). When presented with an investment opportunity, one of the key tasks in assigning value is to estimate the risk. If an investor has no confidence that the expected income will be received from the business (i.e. 0 percent), then he would apply a substantial discount rate to the expected future cash flow or income.

Risk Free Rate. If the receipt of expected future cash flow were guaranteed, then the discount rate used to translate future receipts into present dollars would be the *risk-free rate*. The financial world looks to U.S. government obligations as the benchmark for risk-free investments. In other words, the financial world considers there to be 100 percent certainty the United States Government will pay

its debts in full, and on time. As such, we can look at the rate of return or yield paid or earned on U. S. obligations as a representation of the time value of money for investors.

In theory, to entice investors to contribute money to an investment that is risk-free, a rate of return at least equal to that which is paid on U. S. obligations would be required. A one-year U.S. Treasury bill today earns around 1.5 percent per year. If we determined there was uncertainty as to whether a proposed investment would actually pay the expected returns, then in theory, the investor would require a higher return to compensate for such risk.

Discount Rate. The rate at which future dollars are converted or discounted to present dollars is called the *discount rate*, also commonly referred to as the *hurdle rate*, *cost of capital* or *opportunity cost of capital*. The discount rate is made up of two components, the *risk free rate* (to compensate for the time value of money) and the *risk rate* (to compensate for the uncertainty of the expected future cash flows). This can be represented by the equation $R_f + R = D$, where R_f is the risk free rate, R is the risk rate and D is the discount rate.

Discounting. The mechanism used to adjust the value of a dollar received in the future into value today is called *discounting*. If one were to determine that he or she would pay just 80 cents for a dollar that was expected to be received in one year, then the discount rate is 25 percent. If the time value of money for this particular investor is consistent over time, then for every year a dollar's receipt will be delayed, a discount of 25 percent will be applied.

The present value of a delayed payoff may be found by multiplying the payoff by a discount factor. If C_1 denotes the expected payoff at time period one (1 year from today) then:

$$\text{Present Value (PV)} = \text{Discount Factor} \times C_1$$

The discount factor is expressed as the reciprocal of $1 + \text{rate or return}$:

$$\text{Discount Factor} = 1 / (1+r)$$

The rate of return r is the reward that investors demand for accepting the investment and all of its characteristics. If we use the numbers from the hypothetical example above we find that \$100,000 to be received in one year, discounted at 25 percent is indeed \$80,000.

$$\begin{aligned} PV &= [1 / (1+.25)] * \$100,000 \\ &= [1 / 1.25] * \$100,000 \\ &= 0.80 * \$100,000 \\ &= \$80,000 \end{aligned}$$

To further illustrate how this concept is applied, let's assume that if we buy XYZ business, we will receive \$100,000 at the end of each year for five years. To calculate the present value, list the payment to be received in each year, then discount the dollars to the present value as in Table 1 below.

Year (\$000's)	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Income rec'd:	\$100	\$100	\$100	\$100	\$100
Discount factor (@ 25% / year):	.800	.640	.512	.409	.328
PV of year's cash flow:	\$80	\$64	\$51.2	\$41.0	\$32.8
Value of bus. (\$000's)					\$268.9

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Trade Secrets ... Exposed

Every business has information it would like to keep to itself. Information such as customer lists, contracts, formulas, processes and methods used in the production of goods that are vital to any successful business operation. But, when does the information become a "trade secret"?

Information can be considered a "trade secret" if it meets each of these three criteria.

- 1) It is commercially valuable
- 2) It is guarded from disclosure
- 3) It is not common knowledge

Commercially valuable information is typically defined as information you wouldn't want a competitor to have. Guarding the information from disclosure means keeping the information secret.

In short, if you want to claim that something is a trade secret, you must treat it that way. Physical restraints, like locked filing cabinets, encryption or password protected access to electronic files, and marking or numbering copies of information are all evidence of guarded disclosure. Non-disclosure or confidentiality agreements with employees who must have access to the information to do their jobs can also be evidence that you intend something to be a trade secret. Information that can be obtained by some publicly available source, like a list of phone numbers that could be taken from the phone book, can't be a trade secret.

Though they are considered a form of intellectual property, like patents or copyrights, trade secrets are only protected if they are actually kept secret. If, for example, the owner of a business method obtains a patent on his or her process, it is no longer considered a trade secret but is protected by patent law. Although trade secrets do not enjoy some of the benefits offered by registration, as patents or copyrights, they do have one advantage — they can last forever (or at least as long as the information stays secret) while copyrights and patents have finite terms of protection.

The disadvantage with traded secrets is that since there's no formal method of protection, the question about whether a trade secret has been violated doesn't arise until the information has been released and may have

already caused some damage. Most states have adopted the Uniform Trade Secret Act, which provides for injunctive and monetary damages in cases of misappropriation of trade secrets. The attorney general can also bring action under the Economic Espionage Act of 1996, a federal law that criminalizes misappropriation, copying, destruction or transmission of trade secrets.

The most common types of trade secret misappropriation are 1) wrongful use or disclose by an employee, and 2) a competitor wrongfully obtaining it. In most states, an employee is under duty of loyalty to his employer, which includes the nondisclosure of trade secrets to competitors. In addition, it is wrongful for a competitor to obtain vital secret information from an employee by bribery or other means. The faithless employee also commits a tort by divulging secret trade information.

Can you stop these leaks with "non-compete" clauses? The enforceability of non-competition clauses following termination of employment varies from state to state. Oklahoma, for instance, does not enforce these clauses. However, an employee, even if he is not subject to a non-compete agreement, may not use trade secrets or disclose them to third persons. The employee is *entitled*, however, to use skill, knowledge and general information acquired during the employment relationship. This can be a fine line for an employer. Clearly, you may hire an employee for his general expertise, but you may find yourself in the courtroom if you try to tap into knowledge of a competitor's trade secrets.

If you can't hire the information, how *can* you legally gain access to valuable commercial information that your competitor may have? You can do your own research, purchase and study the competitor's products, or you can wait for an owner to either voluntarily disclose the information or fail to make reasonable efforts to protect.

To protect your own trade secrets, here is what you, as a business owner, should do today:

- 1) Identify what your proprietary information is, using the three

criteria listed at the beginning of this article, and by talking to an expert on intellectual property.

- 2) Educate your employees about trade secrets and the law.
- 3) Explain to your employees what in your organization is proprietary. If they don't know that you consider it secret, it won't be treated that way.
- 4) Take appropriate measures to keep the information secret by physical or electronic restriction, or by non-disclosure and confidentiality agreements with your employees. Carelessly handled information will not be treated as a trade secret.
- 5) Put new employees on notice that you are not interested in obtaining any information that their former employer considers a trade secret and include a clause in their employment agreement to that effect. □

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"There is a time in every man's education when he arrives at the conviction that envy is ignorance; that imitation is suicide; that he must take himself for better, for worse, at his portion; that though the wide universe is full of good, no kernel of nourishing corn can come to him but through his toil bestowed on that plot of ground which is given to him to till."

Ralph Waldo Emerson

What List Is Hotter Than The Hot Prospect List?

Make a list.

Everyone does it. A to-do list, a hot prospect list, a customer list, a 'books you want to read' list, even David Letterman's top-ten list. What lists are you preparing? Are they helping your business? Or, are they just getting in the way?

In sales, there is the *hot prospect* list. That's a list that EVERY salesperson makes. Those prospects or existing customers that are his or her prime targets for the week. That is a bogus list. "Hot?" Hot for whom?

Why don't you make a list of customers and prospects that are hot for you? That's a better, and more honest definition of the word "hot." It's also a much (much) smaller list. In fact, there may be no one on it. However, it's certainly a list you'd want to grow.

Well, I have prepared for you a list of lists that you desperately need to develop if you want to be on top. It is highly unlikely that you currently have ANY of them, but the faster you make them, the sooner you will begin making a ton more sales and keep customers loyal.

One problem. Making this list will require work. Individual work and teamwork.

The first lists are about the sale:

1. List your ten MOST powerful questions.
2. List the questions you ask that your competition DOESN'T ask.
3. List what you say in your sales pitch that your competition DOESN'T say.
4. List what your ads say that your competition's ads DON'T say.
5. List what your brochure says that your competition's brochure DOESN'T say.

Blank papers so far?

Easy list:

6. List your ten most common sales objections.

Hard list:

7. List your BEST responses to common sales objections.

Harder list:

8. List the BEST responses to your most commonly asked questions.

Hardest lists:

9. List your most powerful sales statement.
10. List your most powerful business attraction statement.

Five lists of five:

11. List five ways you ask for the sale.

12. List five ways you follow up after the sales presentation but before the sale.

13. List five ways you follow up after the sale.

14. List five personal ways you provide value to customers between sales.

15. List the five best places you network for new prospects.

And now, the big three ... the sales three. The three that answer the question, "Why should I deal with (buy from) you?"

16. List your "difference," the real difference, between you and the competition. These differences can be both real and perceived.

17. List the "value" you provide to the prospect or customer BEFORE the sale.

18. List the "value" you provide after the sale.

And, an unthought of list that could be the most powerful of them all, if enacted:

19. List the profit you can make the customer.

(NOTE: Do they want your product or do they want to make a profit?)

OK, there's a list of lists. Most of them are painfully obvious. But, fill them out as fast as you can. Most of them you should have had years ago.

And a final list. A personal one:

- 19.5 List the ways you intend to get better at what you do over the next six months. Limit the list to less than five doable actions or tasks. Do one of the improvement items a day, each day of the week. One small dose of everything each week.

One of the coolest parts of lists is that they both remind and memorialize. Your opportunity is to take advantage of the information ... before your competition does. □

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**Jeffrey
Gitomer**

**Did
You
Know?**

According to a recent survey by the University of Maryland, U.S. workers spend an average of 3.7 hours per week engaged in personal online activities while at work, and about 5.9 hours per week using the Internet at home for work-related purposes.

Family FUNding: Wedding

The *USA Today* recently reported that the average wedding costs \$19,000 and includes 200 guests. The honeymoon costs an additional \$3,500. *Bride's Magazine* recently concurred, reporting that the cost of the average U.S. wedding has risen from \$15,208 in 1990, to \$19,104 today. Here is what they presented as an "average budget" for a guest list of 200:

Invitations, Announcements, Thank You Notes, etc.	\$327
Bouquets and Other Flowers	\$756
Photography and Videography	\$1,311
Music	\$830
Clergy, Church, Chapel, Synagogue Fee	\$232
Limousine	\$393
Attendants' Gifts	\$308
Wedding Rings (Bride and Groom)	\$1,016
Engagement Ring	\$3,044
Rehearsal Dinner	\$698
Bride's Wedding Dress	\$823
Bride's Headpiece/Veil	\$166
Bridal Attendants' Apparel*	\$790
Mother of the Bride's Apparel	\$231
Groom's Formalwear (Rented)	\$95
Men's Formalwear (Ushers, Best Man)	\$449
Wedding Reception	\$7,635
GRAND TOTAL	\$19,104

* Cost for average of five bridesmaids dresses (including maid of honor).

Unfortunately, we know of no insurance underwriter that issues wedding insurance, nor are we aware of any government grants available to help you pay for a wedding. However, much to the regret of your daughter, here are some suggestions that the *Motley Fool* recently provided for reducing the cost of a wedding:

► **Involve Friends**

Flatter talented friends by inviting them to participate in the wedding. You need musicians, photographers, bartender, a person to video, a very nice car -- all things that will cost you \$500 - \$900 to have someone else do.

► **Do It Yourself**

There are plenty of before-the-wedding things that can be done by you, your daughter and others. Make the veil (apparently, it is just a headband and tulle), flower arrangements (since the cost is in the labor and not the blooms themselves), cake, and write the invitations in calligraphy ... or design and print them yourself using your computer.

► **Don't Buy "Wedding" Things**

Anything that has the word "wedding" attached to it can instantly fetch a 25 percent or more premium. Buy dresses, not wedding dresses. Shoes, not wedding shoes. Disposable cameras, not wedding disposable cameras. Bubbles, not wedding bubbles.

► **Wedding Dress**

Two thousand dollars is a lot of money. Borrow a dress. Wear mom's, mother-in-law's, sister's or best friend's. Any would be flattered as you start a great new family tradition. Moreover, in all likelihood they have only been worn once! Other sources are consignment shops or finding a beautiful formal dress that happens to be white or cream.

► **Less Is More**

Work very, very hard to reduce the number of guests. Starting with the average of 200, try to cut 50 people. At \$80 per person for food, wine, cake, napkins, plus the effect on every one of your variable costs, this is the fastest way to save. And, there is an upside; a smaller wedding means you can spend more time with the people who mean the most to you.

► **Location, Location, Location**

Orange juice in a Manhattan hotel costs \$8 a glass. Imagine how much beef en croûte with coriander walnut filling will cost. As you consider locations that are meaningful - the town you currently live in, your childhood home, your college town - evaluate comparative costs of living. This is a direct cost to you, but it may also affect the lodging costs of your guests. *Modern Bride* estimates that the same wedding reception in San Diego costing \$4,000

would cost \$9,000 in Chicago and \$15,000 in New York City.

► **Time Is Money**

The easy complement to location is date and time. A wedding on the beach in off-season September is half the price and half the complication of the same wedding in the high season. Having a Saturday night wedding in June means competing with a zillion other brides and grooms for the attention of caterers, photographers, bands and even locations - all of which are going to the highest bidder. Ask the reception site or caterer what the price difference for a daytime wedding or another month would be. Even if you are having a June wedding, choose in-season flowers and in-season food ingredients.

► **Eliminate Response Cards**

Response cards are small cards where guests can check a box indicating that they are attending and return mail them, postage paid. Etiquette dictates that a formal written invitation deserves a formal written response. Hogwash. Response cards, when they are printed, cost nearly as much as the invitation and will increase the weight of the original invitation, not to mention the postage. Ask them to RSVP by phone or email.

► **Have a Cake in the Back Room**

Decorating a big cake takes longer than decorating a small cake, and bakeries charge between \$2.50 and \$6 per person, per slice of wedding cake (which has a different pricing scheme than other cakes). You can cut that cost to \$0.50 per person by having two cakes. Have a small, beautifully decorated cake to photograph, cut into and to put on show. Serve your guests slices of plain sheet cake - cut in the kitchen - they will never know that it didn't come from the pretty cake.

► **No Tschotshkes**

No one leaves a wedding saying, "I had a great time because I got a picture frame," or "They must be in love because I received some chocolates." Wedding favors are an easy line item to cut out. The same with monogrammed cocktail napkins and matchbooks. □

Business Valuation Basics, continued from page 9

The value of XYZ Company is \$268,928 or the sum of the present values of each expected future cash payment. To avoid having to calculate each discount factor, refer to any present value table located at the back of most finance textbooks.

Return on Investment. The return on investment is generally referred to as the cash or profit gained from equity dollars invested. This is also referred to as *Return on Equity (ROE)*. The return can be expressed as a dollar amount, or converted to a percentage by dividing the return by the equity deployed. Typically, returns are calculated on an annual basis and referred to as *annual rate of return*.

$$\text{Dollars Received} / \text{Dollars Originally Invested} = \text{Rate of Return}$$

Return can also be calculated on total capitalization (debt and equity). Such a return would be calculated as follows:

$$\text{Dollars Received} / (\text{Equity Capital} + \text{Debt Capital Invested}) = \text{Return on Total Capitalization}$$

Example: If \$50 was received in year one as a return on \$200 invested, the rate or return would be 25 percent.

The next issue of *The Business Owner* will discuss *Required Rate of Return* and *Market Rates of Return*. □

Military Leave, continued from page 9

Service of 31 to 180 days: Application for reinstatement must be submitted no later than 14 days after completion of military duty.

Service of 181 or more days: Application for reinstatement must be submitted no later than 90 days after completion of military duty.

The employee must report to work as soon as possible. If the reason for the employee's delay is not related to military duties, the employee is subject to the personnel policies and practices the employer would normally apply to employees with unexcused absences.

The deadline for reinstatement may be extended for up to two years for persons who are convalescing due to an injury or disability incurred or aggravated during military service, and employers must make reasonable accommodations for the disability. □

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Cost Drivers and Where to Look to Lower Cost, continued from page 3

Cost Driver #4: Linkages

The cost of a value activity is frequently affected by how other activities are performed. These are called linkages. Some of the most common linkages are between direct and indirect activities (e.g., machining and maintenance), quality assurance and other activities (e.g., inspection and after-sale service), activities that must be coordinated (e.g., inbound logistics and operations), and between activities that are alternative ways of achieving the result (e.g., advertising and direct sale).

The only way to survive and thrive is to continually lower the cost that it takes to produce each unit.

Identifying linkages requires that we ask, "What are all the other activities elsewhere that have or might have an impact on the cost of performing this activity?"

Important linkages exist within a company and between a firm and its suppliers and channels (sales reps, distributors, delivery

systems). A firm can identify linkage costs or inefficiencies by examining how the behavior of suppliers or channels affects the cost of each of its other activities and visa versa.

Linkages with suppliers tend to center on suppliers' product design characteristics, service, quality assurance procedures, packaging, delivery procedures and order processing. For example, a supplier may be delivering items that are packaged in a way that requires too much time to unpack and ready for processing, thus hurting your productivity.

Channel linkages, such as those related to how you sell or distribute your goods or services, mirror those of supplier linkages and include such items as the mode of transportation, location of distribution hubs, manner of delivery and services provided.

Cost Driver #5: Vertical Integration

Vertical integration is the expansion of the value activities that a firm provides in-house as opposed to outsourcing to a third party. For example, a company has the choice of making parts in-house or having a vendor make them. Or a firm could choose to handle their deliveries with their own trucks and drivers, or they could outsource this value activity to third party carriers. Every value activity should be evaluated periodically to assess what method will reduce costs and best meet the value-added process adopted by the company. The goal is always expense reduction, improving the delivery to the client of your particular value-add, and solidifying your uniqueness compared to your competition.

Cost Driver #6: Timing

Timing, itself, can drive cost. When you begin in business, or enter a new business or add a new product or service, can greatly affect the cost required to establish operations and educate the marketplace that you exist and why they should choose you. Often, the first company to offer a service enjoys easier and less

costly penetration/customer awareness. Established competitors might also enjoy lower cost due to the fact that they have already paid for all or a part of their physical assets and they may be able to operate more efficiently because of their experience.

Later entrants might also be able to enjoy cost advantages over their competitors that have been in business longer. For example, older firms may be stuck with older technology that is much less efficient and may not have the capabilities offered by newer machinery. Older firms may also be stuck in a location that is now less than ideal.

Almost any firm can use timing to reduce costs over competitors by simply buying during times of lower prices. This skill alone could produce a powerful cost advantage over competitors. Businesses that require a significant amount of capital equipment can reduce costs by buying used equipment, or buying when prices are depressed. Inventory purchase costs can sometimes be influenced in a similar manner.

Cost Driver #7: Interrelationships

Interrelationships are how businesses or business units share the cost of a value activity. Sharing a value activity serves the purpose of increasing volume and therefore reducing per unit costs and improving efficiency. The sharing of a costly technology or piece of equipment might be a way of reducing the cost of delivering a value activity, such as the sharing of pre-press equipment and personnel by several print shop locations. Additionally, the pursuit of knowledge and learning can be considered a value activity in itself, indirectly. As such, a franchisor may help franchisees move down the learning curve faster by becoming a storehouse of knowledge and best practices and disseminating this information to all franchisees. Trade associations play the same valuable role.

Cost Driver #8: Discretionary Policies

Ways of doing things, such as policies and procedures, often reflect a firm's strategy and involve deliberate tradeoffs between cost and differentiation. Some of the choices that tend to have the biggest impact on costs include:

- Product configuration.
- Performance and features.
- Mix and variety of products offered.
- Level of service provided.
- Spending rate on marketing.
- Delivery time.
- Buyers served.
- Channels employed.
- Technology chosen.
- Scale, timing, or other cost drivers.

Almost any firm can use timing to reduce costs over competitors by simply buying during times of lower prices.

continued on next page

Cost Drivers and Where to Look to Lower Cost, continued from previous page

- Specification of raw materials.
- Wages paid and amenities provided to employees.
- Human resource policies such as training, hiring and employee motivation.
- Procedures for scheduling production, maintenance, sales calls and other activities.

Cost Driver #9: Location

Geographic location of a value activity can affect cost, as can its location relative to other value activities. While location frequently reflects a policy choice, it can also stem from history, the location of inputs and other factors. Hence, location should be treated as a separate cost driver. Location affects costs in a number of ways. Locations differ in the prevailing cost of labor; talent pool; raw material quality, cost and availability; energy costs; tax rates; climate; cultural norms, tastes; and other factors. Location relative to suppliers is an important factor in inbound logistical cost, while location relative to buyers affects outbound logistical cost. The affect location can have on the various parts of a business should be considered when a site is selected. □

This article is the fourth in a series on the state-of-the-art in competitive theory. The basis of this article, and the series, is the work by a Michael E. Porter as described in his two books, Competitive Strategy and Competitive Advantage.

- Part 1: *Introduction to Competitive Strategy and Competitive Advantage (2002 Nov/Dec issue)*
- Part 2: *Industry Structure and The Five Competitive Forces that Influence Industry Profitability (2003 Jan/Feb issue)*
- Part 3: *How to Pursue a Differentiation as a Path for Superior Profits (2003 Mar/Apr Issue)*
- > Part 4: *Cost Drivers and Where to Look to Lower Cost (This issue of The Business Owner)*
- Part 5: *Customer Perception and Signaling (2003 Jul/Aug issue)*
- Part 6: *Buyer Value and The Value Chain (2003 Sep/Oct issue)*
- Part 7: *Switching Costs and Substitution (2003 Nov/Dec issue)*

Coming Up in *The Business Owner*

The Power Of Time and Compounding of Investment Returns	What To Look For In a Business Appraiser	Buyer Value and The Value Chain
■	■	■
Disability Insurance	Employee Stock Option Plans (ESOPs) - An Overview	Disability Insurance
■	■	■
Writing a Business Plan In One Hour/Refining It With 20 Minutes a Week	Binding Signatures and Signature Pages For Legal Documents	Things That Can Create Officer and Owner Liability For Company Debts
■	■	■
Switching Costs and Substitution	The Business Owner's Big Three	What Is A Fair Return on Investment?
■	■	■
Small Disadvantaged Business Status, Explained	Customer Perception and Signaling	Small Business Health Plans

If you need to renew, or have any comments or questions, just call us at (800) 634-0605 or email info@TheBusinessOwner.com.

QA Pursuing Collection Via Small Claims Court

Q: Is there any less expensive way to forcefully pursue payment of an unpaid invoice? It just does not make sense to get my attorney involved when the dollar amounts are small.

A: For amounts under \$7,500 you should consider small claims court. This entails simply filing a "notice of small claim" form with the district courthouse of the county in which the debtor resides. The forms can be obtained in person or by mail. The first step is to determine the maximum amount allowed under small claims in the state of the debtor. Each state is different, generally under \$7,500. Some states, like Massachusetts, have a maximum of just \$2,000.

The filing fee is usually around \$20 and the information required is typically just the name, address and telephone number of the person or corporation you are bringing the claim against, and the amount of your claim.

Upon receipt of your application, the small claims court clerk will assign a case number and trial date and provide you with such via a 'Notice of Small Claims,' usually within three to four weeks. You must then provide a copy to the defendant within 10 days of the trial. However, you are not permitted to deliver these papers yourself! You must use certified mail, county sheriff, process server (listed in the Yellow Pages under "Process Servers"), or any person 18 years of age or older who is not involved in the case.

You must then file proof that the defendant was served with the notice. If the Sheriff or a professional process server delivers the notice, he or she will complete a certificate of service and send the original to the court on your behalf. If another person serves the notice, you must have that person sign an affidavit of service before a notary public. If the defendant is served by mail, file the return receipt as proof with the court clerk.

When you (or your representative) arrive at the courtroom, check in with the court clerk. When the case is called, you will be sworn in along with the defendant and any witnesses. The judge will ask you to explain your side of the case. Provide the important facts including any evidence or papers that support your case. If you have any witnesses, ask the judge to allow them to testify as well. When both sides have been heard, the judge will make a judgment. Such will be binding and have the full force of the law. It will allow for a garnishment of wages or a lien on the assets of a business. □

Split-Dollar Insurance Tax Treatment To Change

Many owners of small and midsize businesses obtain insurance benefits through so called split-dollar life insurance arrangements. The IRS has recently announced that it will issue new regulations that will significantly change the tax treatment of split-dollar life insurance arrangements.

Split-dollar life insurance is an arrangement between an insured and a party who pays the premiums that provides for the insurance proceeds to be shared by the insured, typically an employee, and the party who pays the premiums, typically the employer. Generally the policies fall into one of two categories:

1. The employee owns the policy and files a collateral assignment with the insurer to protect the employer's right to recoup the premiums paid, or
2. The employer owns the policy and files a policy endorsement with the insurer to protect the employee's right to receive all of the death benefits after the employer has recouped the premiums paid.

It is expected that the new IRS rules will provide that if the employee owns the policy and is obligated to repay the premiums to the employer (out of policy benefits or otherwise), premiums paid by the employer are treated as loans to the employee. These loans will be subject to original issue discount and below-market loan rules. This means that an amount equal to a market rate of interest on the loans will be deemed paid by the employer to the employee, and the same amount will be deemed paid to the employee as additional compensation from the employer. If the employee is not obligated to repay the premiums



paid by the employer, then premiums paid by the employer are treated as additional compensation paid to the employee.

If the employer owns the policy, the employee will be taxed on the current annual value of the life insurance protection provided under the policy, but not on the equity build up in the policy (the excess of the cash surrender value of the policy over the portion of policy benefits payable to the employer).

The current annual value of the life insurance protection will be determined using rates prescribed by the IRS. For policies entered into before January 28, 2002; the annual value of the life

insurance protection will be the lesser of the current P.S. 58 rates or the insurance company's term premium rate that is generally available for term insurance and regularly sold through the company's normal distribution channels. Special guidance is set forth for split-dollar arrangements entered into after 1/23/02 but before the date that the new regulations are formally adopted.

For split-dollar arrangements created on or before January 28, 2002, under which there will be a full repayment of premiums to the employer, the IRS will not treat the employee as receiving the full value of the policy upon termination of the split-dollar arrangement if, (i) the arrangement (but not the insurance itself) is terminated prior to January 1, 2004; or (ii) for all periods after January 1, 2004, all premiums paid by the employer are treated as loans to the employee, and the loans are reported in compliance with the original issue discount and below-market loan rules of IRC §§ 1271-1275 and § 7872. The IRS has not indicated what the consequences will be if neither action is taken. □

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