SEPTEMBER / OCTOBER 2003

The Business owner®

Buyer Value and the Value Chain

A business is actually a collection of activities that are performed to design, produce, market, deliver and support its product or service. The purpose of these activities, of course, is to create value for customers. Value is delivered to customers by helping them, via products or services, lower cost or raise performance. A company earns a profit if the value created – as evidenced by what buyers are willing to pay – exceeds the cost incurred.

Value Activities

Value activities are the distinct activities that a business performs; the building blocks by which a firm creates a product or service. Every value activity involves purchased inputs, human resources (labor and management), and some form of technology to perform its function. Each value activity also uses and creates information, such as buyer data (order entry), performance parameters (testing), and product defect rates. Value activities may also create financial assets such as inventory and accounts receivable, or liabilities such as accounts payable.

Value activities can be divided into two broad types … primary and support. Primary activities are the activities involved in the physical creation of the product, its sale and transfer, and its after-sale assistance. Support activities support the primary activities and each other by providing purchased inputs, technology, human resources and various other functions.

How each activity is performed combined with its economics will determine whether a firm is high or low cost relative to its competitors. How each value activity is performed will also determine the contribution to buyer needs and hence differentiation.

Keep in mind that even value activities representing only a small percentage of total cost can nevertheless have a major impact on differentiation. For example, inspection may represent only one percent of cost, but shipping even one defective package of drugs to a buyer can have substantial negative repercussions.

The Value Chain

To fully understand the important component inputs that lead to the delivery of value, a firm must be broken down into its component parts. The process for doing so is called "the value chain." A company's value chain, and the way it performs the individual activities that make up its value chain,

Continued on page 9

ALSO IN THIS ISSUE

- Control vs. Minority Ownership Interests
- *Scam Alert:* Don't Be the Next to Get Taken
- Where to Find Your Next Sale
- Aesop on Family Business

Special Advisory: Writing off Capital Expenditures

- Should You Take Advantage of the Acceleration Options?
- The 6,000 lb. vehicle laws explained
- Section 179 rules made simple

- Lessons from the Creator of Three Fortune 1,000 companies
- Should You Make Voluntary, Non-Deductible Retirement Plan Contributions?

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for owners of small and mid-size businesses and the professionals who advise them ... since 1975.

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From The Editor

David L. Perkins, Jr.

Greetings Business Owner:

What a great time to be a business owner! Two years into a recession and our worst fears have not materialized. In fact, our focus has made us leaner, more efficient, faster and more competitive. Lower interest rates have provided incredible relief and some of our pesky competitors have gone out of business, clearing the way for us to garner a larger share of the market and more comfortable profit margins. Thank goodness for recessions!

If you are getting ready to make capital expenditures, this issue is for you. Enclosed is all the detail you need to understand the basics of how capital expenditures are expensed in a business. Included are the special, limited-time incentives currently available and the rules on the expensing of company vehicles.

Oh, and don't miss the "Scam Alert" article. It is unfathomable the number of business owners that are "taken" by con artist that prey on the good efforts, struggles and dreams of the private business person. Whenever you learn about an unscrupulous purveyor, tell others. Even if you have been taken yourself, resist the temptation to keep it to yourself. File complaints and contact your newspaper and trade association. Put your investment in knowledge to good use … saving someone else from having to learn the hard way.

David L. Perkins, Jr.
Publisher and Editor

TABLE OF CONTENTS

1 **Buyer Value and the Value Chain**
Strategy/Profit Maximization

3 **Non-Deductible Retirement Contributions**
Q & A / Retirement Planning

4 **Increase Your Cash Flow and Manage It More Effectively**
Cash Flow

5 ***Valuation Basics:* Control and Minority Ownership**
Business Valuation

6 ***Family Business:* Aesop on Family**
Family Business

7 ***Gitomer:* The Last Ten Sales Will Show You the Eleventh**
Sales

8 ***Book Review:* The Making of a Blockbuster**
Book Review

9 **Business Owner's Toolbox**

SPECIAL TAX ADVISORY

10 **Expensing Capital Assets**
Tax

11 **Company Vehicle Tax Laws (Section 179, Bonus Depreciation and Other)**
Tax

12 **Summary of Accelerated Depreciation Opportunities for Capital Expenditures**
Tax

13 **Could You Qualify for the 6,000 lb. Vehicle Rules?**
Tax

14 **Should You Take Advantage of the Accelerated Expensing Provisions?**
Tax

16 **International Profit Associates**
$cam Alert

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Q&A Non-Deductible Retirement Contributions

Q: The limits to how much I can contribute into my retirement account, on a deductible basis, are pretty low. Does it make sense to make contributions that are not tax deductible?

A: Yes. Even though additional contributions may have to come from after-tax income, the money contributed to your retirement account will earn and grow tax-free.

Let's look at the tax-deferred income growth from an annual return point of view. In the table below, we show the pre-tax equivalent returns of earning 8% in a tax-deferred account. The overall tax rate is an estimate of your total federal, state, and local taxes.

Your Overall Tax Rate	Annual Return	Pre-Tax Equivalent*	Bonus Return	Percent Increase
40%	8%	13.3%	5.3%	66%
35%	8%	12.3%	4.3%	54%
30%	8%	11.4%	3.4%	43%

* Formula: Annual Return of 8% divided by 1.00 less tax rate (0.40, 0.35, and 0.30).

The tax deferral of the income from voluntary retirement contributions increases your comparable pre-tax return by 66% if you're in a 40% tax bracket, 54% in the 35% tax bracket, and 42% in the 30% tax bracket.

Two more observations. First, the higher your tax bracket and tax rate the more tax-advantageous it is for you to make voluntary contributions. Compare the 40% tax rate column (which yields a pre-equivalent return of 13.3%) with the 30% column (a pre-tax equivalent return of 11.4%). That's 1.9 more percentage points.

Second, if your investments earn more than 8%, then your pre-tax equivalent return will be higher as well. For example, at the 35% tax rate, the 8% return is equivalent to a 12.3% pre-tax return. Increase the 8% return to 10% and your pre-tax equivalent return increases from 12.3% to 15.4% (10% return divided by .65). That represents an additional 3.1 percentage points on top of the 12.3% rate.

To further illustrate the value of making voluntary contributions, here is the total payoff if you invest an additional $2,000 per year into your retirement account (we assume the $2,000 IRA contribution is made at the end of the year).

Years	Total Contribution	Total Return at 8%	Added Value of Contributions
10	$20,000	$8,973	$28,973
15	$30,000	$24,304	$54,304
20	$40,000	$51,524	$91,524
25	$50,000	$96,212	$146,212

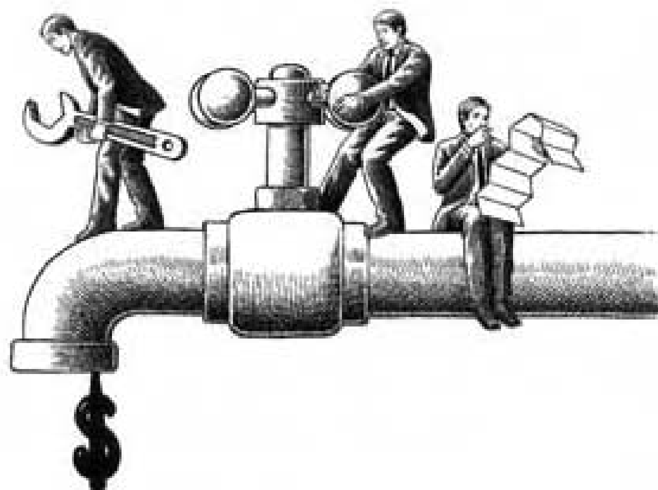
In voluntary retirement contributions, the annual returns compound tax-free every year the money remains in your account. That's why they should be a significant part of your retirement planning. ❐

Increase Your Cash Flow and Manage It More Effectively

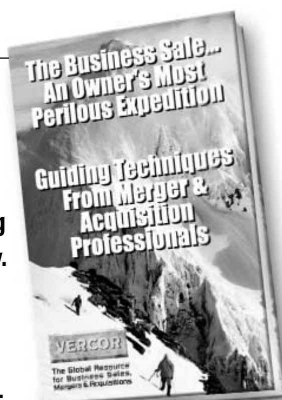
Cash is survival, growth and power. Without it, you're dead: no salary, no employees, no products, no business. Effective cash flow management comes from doing a lot of little things right. Here are some ideas that you should consider applying today.

- Don't overlook the *dramatically* negative effect of a bad receivable write-off. With a 10% profit margin, a $10,000 receivable write-off is equivalent to $100,000 in lost sales ($10,000 write-off divided by .10). It pays to monitor receivables closely.
- Open your mail immediately. Deposit checks on the same day. Consult your bank as to how to speed the processing of deposits, such as grouping local and out-of-state checks in two separate deposits.
- Anticipate shipments and invoice the customer immediately. At a minimum, invoice within one to two days after shipment. Consider offering an early-pay discount.
- Verify all invoices before paying them. Was all of the work completed satisfactorily? Does the price conform to the job order and/or price quote? Is the math correct? Was the invoice already paid? If sales tax is charged, is it applicable and properly computed?
- Insist on specifics. If a delinquent customer hasn't yet mailed the payment, pin him or her down on the exact date the payment will be mailed. If it's ready now, arrange to pick up the check or pay for overnight delivery.
- Concentrate on increasing sales to *current* customers. It's an established fact that most businesses neglect promoting redesigned or related products to their existing customer base.
- Don't divert cash to high-risk new ideas and products without first building on *existing* products and services. Explore new approaches and new markets to sell your existing products.
- Know your profit margins on each product and concentrate marketing efforts on higher profit margin products. Consider offering your salespeople a higher commission for these sales.
- Get rid of slow-moving inventory. Prepare a special bulletin offering your customers and prospects a one-time discount on these products.

On your niche and products – Most business owners make their living by filling needs that big companies can't or don't have interest in filling. There lies the niche business entrepreneurs work to find. As you search, stay in the product area and industry you know best. Virtually all smaller businesses grow out of the business owner's enthusiasm for his or her company's products or services. That continued enthusiasm is the key to continued success, avoiding trouble and maximizing cash inflow. ❐



The business sale process is a mountain of uncertainty. The right guide is critical for maximizing the selling price of your company.



The Business Sale...An Owner's Most Perilous Expedition provides practical steps to navigate an owner through the uncharted journey of selling a business. It reveals tactics to help sellers:

$24.95

- Understand the role of professional advisors.
- Maximize your chance of success with strategic pre-sales planning
- Prepare your offering documents to best position your company
- Avoid common pitfalls that plague inexperienced sellers
- Evaluate the different types of buyers
- Learn which tangible and intangible assets can elevate value
- Chart a course through sensitive negotiations
- Sustain momentum
- Properly structure the deal

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Valuation Basics: Control and Minority Ownership

Control of a company refers to the ability to "control" the operations and activities of the business. Control allows the controlling person, entity or group to influence or dictate who manages the business, how the company is managed, what the company does, where it operates, compensation levels, whether profits are distributed to shareholders or retained in the company, what investments are made, how the business is capitalized (borrow via debt or equity), and whether and when the business may be sold. As you can see, control is an incredibly important and powerful quality of ownership. Conversely, lack of control is a materially impaired position indeed.

So, What Dictates Who Controls a Business?

Generally, control is associated with an ownership percentage that exceeds 50 percent. This is because the controlling shareholder can win votes that require majority. Keep in mind, however, that the matter of a controlling or non-controlling ownership position is not an either/or proposition. It is rather a matter of degree. Things that commonly tip the balance one way or the other are:

- A company's organizational documents, such as the articles of incorporation and bylaws.
- Statutes (laws) in the state of organization of your business, such as supermajority voting requirements and what are known as "dissolution statutes."
- Distribution of equity ownership.

Distribution of Equity Ownership.

The distribution of the ownership of the equity of your business can significantly influence the control and the value of a minority ownership position. For example, if there are only two equity holders, one with 66 percent and one with 33 percent, then the 33 percent holder typically will have almost no control. However, if there are three owners with equal ownership, each 33 percent shareholder can provide effective control for another of the shareholders, giving control to the two if they work together. This position in itself lends power to the minority. In turn, none of the shareholders has ultimate control thus their shares would not command a premium price unless paired with the shares of another.

The State of Your Organization Impacts Control Issues, Premiums and Discounts.

State statutes affecting non-controlling shareholders' rights vary from state to state. For example, some stipulate that a simple majority can approve major actions such as the sale of the business. Other states require a two-thirds or greater majority to approve such actions. This means that a non-controlling interest of just over one-third has the power to block many corporate actions. This characteristic adds to the power of the minority share, detracts from that of the majority, and improves the relative value characteristics. States also vary in the power they provide to minority stockholders that dispute value received in the sale of their business, and in the power they provide minority stockholders to force a buyout of their shares.

How Does Control Affect The Value Of Ownership Interests?

Control interests will sell for higher values than non-control positions, leading to what is referred to as control premiums or their counterpart, minority discounts. Studies have documented lack-of-control discounts averaging 25 percent to 30 percent for publicly traded companies. Similarly, premiums for companies that are going from lack-of-control to control positions are in the 35 percent to 45 percent range. The discounts and premiums for privately held companies and shares are usually much larger.

Discount or Premium from What Basis?

Control discounts and premiums are commonly misunderstood and commonly misapplied. When a private company sells in its entirety, it typically sells 100 percent and the price that is paid is for full control. Let's say a company sold for $1 million and had a single shareholder, so all the money went to the sole owner. No premium is considered to have been paid; rather the price paid was simply the value of the business. If we say that a similar company has two shareholders, split 66 percent and 33 percent respectively, and the minority shareholder wished to sell, then what would his or her 33 percentage be worth? One could argue that a 33 percent stake should be worth $333,333, but finding someone to pay such a price for a non-control position would be improbable. What would the fair market value be? Somewhere between $0 and $333,333, depending on the particular characteristics. Control premiums really don't occur except when a public company is purchased and a premium is paid over the share price at which individual non-control shares are traded on the open market (i.e. an exchange, like the New York Stock Exchange). ❐

> **"Nothing is more dangerous than an idea when it is the only one you have."**
>
> *Roger Von Oech,*
> *author of* Whack on the Side of the Head

Family Business: Aesop on Family

One of Aesop's fables is about the strength that can come from keeping families together.

> *Once there was a father who summoned his three children to his bed as he neared death. He wanted to give them a final gift to help them in life. He reached under his pillow and pulled out a bundle of three sticks tied together with a cord. He then gave the bundle to his first child and asked him to break it. He could not. He then asked his second child to do the same. She could not. Nor could the third.*
>
> *The father then took the bundle, untied the cord, and gave one stick to each of his children and asked each to break the stick that they now held. They each succeeded in breaking their individual stick.*
>
> *"Children," he said, "this illustrates that, like the sticks, you are stronger together than you are separately."*

In an elegantly simple way, this fable speaks to us about the wisdom of holding families together. It can also be interpreted to speak to the power of holding family businesses and assets together. However, in spite of best intentions and even inspired planning, being part of a family in business does not always make the individuals feel stronger. In some families, the cord is broken or comes unraveled because the pressure to separate is stronger than the cord that binds the family together. Sometimes the problem lies in what the cord is made.

In your case, what is the cord that holds your family and business together? Ponder this question, and it could lead to a deeper understanding of why you are really in business together and what is the vision for the future.

In some families, there is a long silence when they are asked of what their cord is made. Often, an elder family member, maybe the founder, will slowly raise his or her hand. "I guess it is me … maybe it is just me that holds this family and business together."

When it is the founder that holds the family together, it is often a strong bundle, but only strong as long as the founder is around. When he or she is gone, the group will only stay together if they can find a new binding force to replace the personality of the outgoing leader.

Another common answer to what binds the family and family business together is "our values," or "our spiritual beliefs," or "our love for each other." This is to say that the cord is made of big ideas about what life, work, family and commitments are all about.

When we explore further the thoughts and feelings that bind a particular family and their business together, usually the view differs from family member to family member. And, for some, being a part of a bundle is a great thing! For others, the cord is binding, creating constraints … and relationships that are "too close for comfort." Some members would like to be out of the bundle but fear the consequences of leaving.

We also find that the cord is often actually a braid of several things that hold the family together, some positive and others not. Typically, the threads within the braided cord are a mixture of emotions and "big ideas."

So, think about what is holding the stakeholders in your family business together. Ask yourself and those in your family:

- To what degree is it about emotions?
- Are the emotions ones that are good for people to live with?
- Is it the influence of a personality that holds the group together?
- If it is, what is likely to happen when he or she is gone?
- Is part of the tie that binds your family business together about your values and beliefs?
- If it is about values, how clear are you as a family as to what those specific values are?
- Have you ever put them into words or a statement of family mission or values?
- In the best-case scenario, of what would you like your family's cord to be made?
- Can a family member really feel like they are part of the family if they choose not to be part of the business bundle?

Think about telling Aesop's fable of the bundle of sticks at your next family meeting. Then ask your family to think about what really is holding it all together. The discussion alone may create a stronger cord. ❒

This article written by Joe Paul of the Aspen Family Business Group (AFBG), a periodic contributor to The Business Owner. *For information on their consulting, educational services and publications, see www.AspenFamilyBusiness.com.*

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The Last Ten Sales Will Show You the Eleventh

Capture and repeat your success habits. It's an easy concept. So easy that it's never used.

Salespeople continue to fight the same battles, sale after sale. Price is too high. Can't get an appointment. Prospect is satisfied with their present supplier. Prospect is taking bids from several vendors. Can't reach the decision maker.
Blah, Blah, Blah …

The solution? Study history. No, not American history. You don't care who Franklin Pierce's vice president was, do you? Study your own history. Go back to:

- Your last ten leads.
- Your last ten appointments.
- Your last ten sales calls.
- Your last ten sales.
- Your last ten repeat sales.
- Your last ten referrals.
- Your last ten lost sales.
- Your last ten calls for service help.
- Your last ten customer complaints.
- Your last ten lost customers.
- Your last ten testimonials.

Jeffrey Gitomer

That's enough history to predict the future. Actually, it's enough history to ALTER the future. Your future. That's enough information to cure all your ills and double your sales.

Ok, maybe you need to do the list with 25 of each, but that sounds like work. And salespeople aren't willing to do the hard work it takes to make sales easy. Ten sounds like a more workable number. So let's just start there.

And, when you ask yourself the question, ask probing questions and write the answers on paper. This will make it easier to identify the trends and figure out how to eliminate the mistakes, conserve time and money, prevent problems from re-occurring and focus your energy on what has been successful.

For example, let's take the initial history question: *List your last ten leads.* Ask yourself, Where did the lead come from? What happened? Did I make the sale? Can I repeat that? What do I have to do? What's my plan to do it? Is this my best source of leads? What's the cost? What's the reward? What's the repercussion of not doing it?

Get it? By simply asking yourself these real-world, obvious questions, you come up with relevant answers to help you win the next sale. Here's another example. Keep in mind that each initial question breeds different "depth questions."

List your last ten sales appointments. How did I make each of them? Where were they held? Which ones resulted in sales? How many total sales did I make? Which type resulted in a sale? How can I repeat my best ones?

List your last ten sales calls. How long was each sales call? What was the presentation like? Was there a decision maker present? Was price an issue? What were the objections? How did the sales presentation end? What could I have done differently? How long after the appointment did it take to make a decision? Did they buy?

Other questions could include:
Did I have rapport before I started?
How was my humor?
How did I ask for the sale?
How eager was the customer to buy?
Did I get a referral?

I think you get the idea. Have a team? Get each sales person to do this and your information will be staggering.

One more example:
List your last ten sales. Where did each sale come from? Category? How long was each presentation? How long did it take to complete the sale? What was the amount of each sale? Was I a previous friend? How good was the rapport? Did he hammer my price? How did I ask for the sale?

Well, that's the strategy. And, even though I didn't list each question, I think you can take it from here. This concept has certainly opened my eyes to the probability of making future sales by studying the sales history. It's a strategy you can implement and garner more sales.

You've heard the expression "history repeats itself." Well, so does sales history. All you have to do to repeat the victories is study how you won before – and eliminate how you lost. ❒

Jeffrey Gitomer is author of The Sales Bible, and Customer Satisfaction is Worthless, Customer Loyalty is Priceless. He is President of Charlotte-based Buy Gitomer, gives seminars, runs annual sales meetings, and conducts Internet training programs on selling and customer service at www.trainone.com. He can be reached at 704/333-1112 or e-mail to salesman@gitomer.com
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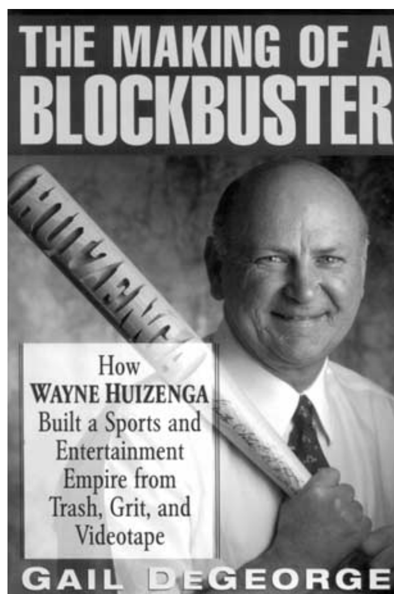
"The metaphor is probably the most fertile power possessed by man."

Jose' Ortega y Gasset,
Spanish Philosopher

Book Review: The Making of a Blockbuster

Wayne Huizenga has built three Fortune 1,000 companies. From a single trash truck in 1962, he built Waste Management, Inc., which did $11 Billion in revenue in 2002. In 1987, he purchased a 35 percent interest in an 18-store video rental chain called Blockbuster Video, for $18 million. The business sold for $8.4 billion in 1994. His next venture sought to revolutionize the way automobiles are sold in the United States. AutoNation had $20 billion in revenue when Huizenga departed in 2002.



The Making of a Blockbuster chronicles the history of Huizenga and how he built Blockbuster Video into an empire and made billions. Regardless of whether you agree with all of his practices, the book is filled with lessons that any business owner could use. Here are his suggestions.

On Spotting Opportunity: Identify an industry that is not meeting customer needs. For example, video rental stores in the mid 1980's were typically small, dirty, mom-and-pop stores with a poor selection and a sub-standard location. Huizenga recognized the value in the Blockbuster concept of offering a huge selection of videos from clean, well-lit, comfortable stores with friendly and well-dressed staff.

On Buying vs. Starting a Business: Wayne has always started with existing businesses. He says if you simply have an idea, it can take a long time to get it working. Buying into an already established business that is working well is a much faster way to do it.

On Identifying Your Passion: Wayne says his passion is making money, and increasing profits every month. He just had to pick up garbage and rent videos to make money.

On Selecting the Right Talent: People are the name of the game. You can sit here and come up with the greatest idea in the world, but if you don't have the right people to execute the business plan, it will never get off the ground. Every person you hire counts.

Business Strategy: If you are going to do something and be successful, you have to be the low-cost provider. Deliver more value at lower cost. Consumers have limited money, they want value.

Work Ethic: When you are in business, every hour counts. During his years in trash hauling, he'd wake up at 2am, haul trash until noon, then put on a suit and tie and solicit new business all afternoon. He has always been the first person to work. When traveling, he travels in the off-hours – before 7am and after 7pm. The daytime is for working – not sitting on a plane.

The information herein was drawn from The Making of a Blockbuster *and from an article written by Justin Martin that appeared in the May 2003 issue of* Fortune Small Business. ❐

Did You Know?

The Federal Government estimated that in 2002, U.S. businesses spent a total of 2.75 billion hours complying with federal tax laws. If we assume that each business had to pay, in some form, $50 for each hour worked, the total cost to U.S. businesses in 2002 was something in the order of $137 billion … before any taxes were actually paid.

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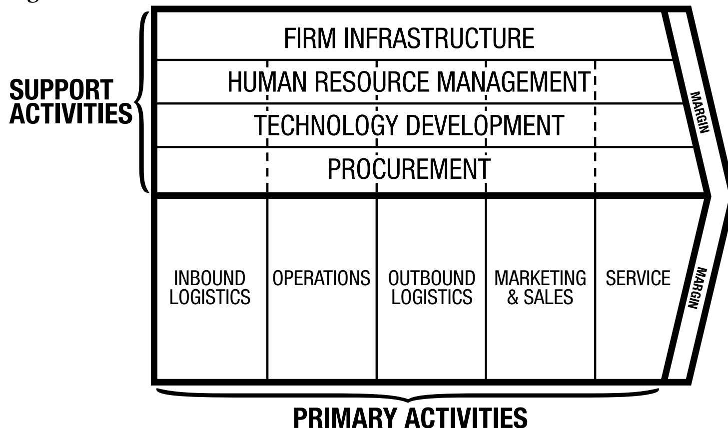
"It's up to you now, Miller. The only thing that can save us is an accounting breakthrough."

Buyer Value and the Value Chain, **continued from cover**

are a reflection of a business' history, people, vendors, channels (distributors, resellers, etc.), strategy, approach to implementing its strategy, and the underlying economics of the activities themselves.

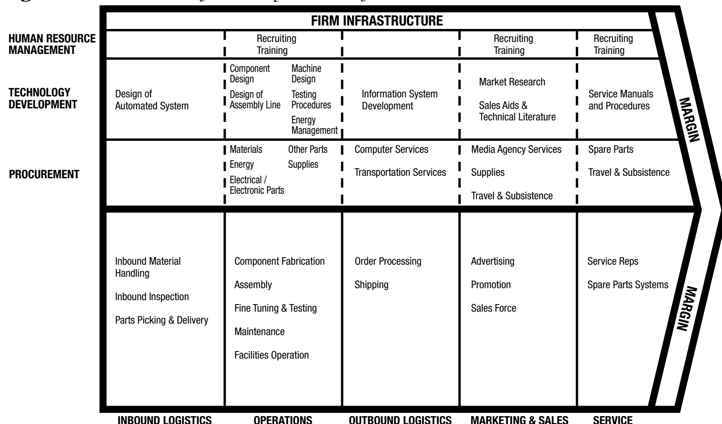
Construction of the value chain of a business enables a deeper understanding of how value is created and delivered, and illuminates opportunities to improve. Each discrete activity performed by a firm can contribute to a firm's relative cost position and create a basis for differentiation. A firm gains an advantage over their competitors by performing these strategically important activities more cheaply or better than the competition. The accompanying graphic, Figure 1, shows a generic value chain.

Figure 1. *The Generic Value Chain*



Starting with the generic chain, the task is to identify the individual value activities in your firm. Each generic category can be divided into discrete activities. For example, the marketing and sales category can be divided into marketing management, advertising, sales force administration, sales force operations and technical literature and promotion. Below, Figure 2, is a fully completed value chain for a copier manufacturer.

Figure 2. *Value Chain for a Copier Manufacturer*



In defining relevant value activities, isolate activities that have different economics, a high potential impact on differentiation, or represent a significant or growing proportion of cost. Broad functions such as fabrication or marketing must be subdivided into activities. Your firm's product flow or paper flow can also be useful in doing so.

Continued on page 15

Business Owner's Toolbox

Free Marketing via Your Vehicles

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You pay handsomely for advertising and marketing, but why don't you take advantage of free means of advertising? Consider using the license plate areas of your personal and work vehicles as ad space, just as you do for your favorite college or ball team or the dealership at which you bought your car. A quick search on the Internet under "custom license plates" will provide a bevy of services that will print custom license plate frames at reasonable prices. Put them on all your vehicles, front and back.

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Expensing Capital Assets

Capital assets are tangible assets that have a limited useful life of more than one year. Common capital assets are furniture, fixtures, machinery, equipment, tools, automobiles, trucks and buildings. The cost incurred in purchasing or building a capital asset used for business purposes cannot be expensed when or as it is incurred, but must be expensed via depreciation over its estimated useful life as stipulated by IRS tables (at least for tax purposes). This applies whether you use the cash or accrual basis of accounting.

Intangibles such as non-compete agreements, franchise rights, patents, copyrights or goodwill items that sometimes arise when a business is purchased cannot be depreciated because they do not have a determinable useful life. Instead, purchased intangible assets are *amortized* (similar to depreciation in that it is an expense) over a 15-year period.

Land cannot be depreciated as it does not have a finite life and does not wear out or get used up. Only improvement to land, such as buildings, can be depreciated as such improvement has a finite useful life. For more information, see IRS publication 551.

Depreciation begins in the year that the asset is placed in service. An asset is considered to be placed in service when it is ready and available for a specific use in your business. Depreciation ends when the asset has been fully depreciated according to the IRS prescribed schedule or when the asset is removed from service in your business (such as when it is sold), whichever is sooner.

The amount that is depreciated is called the "basis," or depreciable basis. A basis is figured by totaling the cost incurred in acquiring it including sales tax, freight charges, installation and testing. The cost includes the amount you pay in cash, debt obligations, or exchange of other property or services. If you construct, build or otherwise produce property for use in your business, you will need to figure your basis based on the cost incurred. Special guidelines for doing so are in IRS publication 551.

The depreciation schedule that must be used for most depreciable assets is referred to as MACRS (Modified Accelerated Cost Recovery Systems). You can find MACRS schedules in IRS publication 946. If you use property for business and personal use, you can deduct depreciation only to the extent of business use.

Most depreciable assets used in a for-profit U.S. located business will use what is called the GDS system of MACRS depreciation. Here is the useful life of various commonly used types of capital assets:

Property depreciated over five years: autos, buses, trucks, computers and computer peripherals, office machinery and equipment

Property depreciated over seven years: office furniture and fixtures, agricultural machinery and equipment

Property depreciated over 15 years: improvements to land such as buildings and related landscaping type improvements.

Rapid Depreciation Opportunities

Reagan era tax code changes approved the use of special accelerated depreciation tables for certain capital assets. Those tables still exist and are used by most taxpayers. Accelerated depreciation means a faster write-off of the cost of the capital asset, resulting in lower profits and lower taxes today. In later years, however, depreciation expense deductions are lower … producing higher profits and taxes.

New tax legislation in 2002 and 2003 brought about additional tax laws that provide for even more rapid write-off of capital expenditures. The two forms are Section 179 and special bonus depreciation provisions.

Section 179: Section 179 refers to the IRS code section that contains this legislation, which allows all or a part of the cost of a qualifying capital expenditure to be expensed in the same year that the asset was placed in service (generally, when it was purchased), "off the top," up to a limit. The 179 deduction limit was raised this year, temporarily, from $25,000 to $100,000 through 2005. This means that as much as $100,000 of depreciable property, such as machinery or equipment, can be expensed in the year of purchase. Section 179 applies equally to new and used capital equipment purchases.

The 179 deduction is also limited to the amount of taxable income that is generated by the taxpayer. In other words, your 179 deduction cannot exceed your taxable income before the deduction is applied. Section 179 deductions technically are not depreciation, but a deduction in and of itself. The amount of any 179 deduction is subtracted from the depreciable basis of the asset when the depreciation schedule is set-up.

Section 179 deductions may only be taken on assets that are used at least 50 percent for business purposes. And the annual depreciation and Section 179 deductions are limited if the asset is a transportation vehicle that weights less than 6,000 lbs. See the accompanying article in this issue of *The Business Owner* for an explanation of the rules the govern the depreciation of company vehicles, and talk to your accountant.

Continued on page 12

Company Vehicle Tax Laws (Section 179, Bonus Depreciation and Other)

The recent tax law changes accelerated the depreciation allowances for business-use vehicles and generated a surge in interest and questions regarding the rules that govern the expensing of the cost of such vehicles. This article will answer the questions.

If you use a vehicle in your business for purposes other than transportation to and from work, you may deduct the expense including the erosion its value over time. There are two ways in which you may do so: 1) standard mileage rate method, or 2) actual cost method.

Standard Mileage Rate Method

The standard mileage rate method is a simple way to figure the amount of vehicle expense allowable. All you must do is keep a log of the miles driven for business purposes and multiply the total by the IRS per-mile rate for the tax year. The rate varies from year-to-year. It was 36.5 cents in 2002 and is 36 cents in 2003. For example, if you drive 10,000 miles for business in 2003, your total IRS reimbursement (the amount you may expenses against your business revenue to reduce your taxable profit) is $3,600 (10,000 multiplied by .36 cents).

Use of this method eliminates the need for you to keep and track actual automobile fuel, repair, maintenance and depreciation expense. As such, you would not deduct these actual expenses from your taxable income – just the amount allowed under the per mile reimbursement rate calculation. This means that the reimbursement amount under this method contains a component that is meant to reimburse you for the annual erosion in value and functionality of your car (depreciation). In 2002, the depreciation amount was .11 of the 36.5 cents per mile allowance.

If you wish to use the standard mileage rate method for a particular vehicle, you must use this method, or have used it in the first year that the vehicle was put into service in your business. If the standard mileage rate was used in the first year, either method may be used in the ensuing years. However, if you switch from the standard rate method to the actual cost method in a later year but before your car is fully depreciated, you will have to estimate the remaining useful life of the vehicle and begin a straight-line depreciation (talk to your accountant).

Important note: If you use the standard mileage rate method you will NOT be able to use or take any of the other depreciation or rapid expensing provisions of the tax code, such as regular depreciation, special depreciation allowances or the section 179 write-off. If you wish to take advantage of these breaks, which can result in much higher first year write-offs against income, you will need to use the actual cost method (explained below).

Note: As a business owner, you may deduct interest expense on a vehicle loan to the extent that you use the vehicle for business purposes regardless of the method used to figure your automobile expenses.

Actual Cost Method

If you choose to use the actual cost method to justify the expensing of vehicles used for business use, the task simply entails keeping track of:

a. Actual expenses incurred in the purchase, operation, maintenance and insuring of the vehicle, and
b. Percent of vehicle usage that is business vs. non-business (via the miles driven for each).

If you use your vehicle for both business and personal use, you must divide your total vehicle expenses between business and personal use. You do this based on the miles driven for each. For example, if you drove your vehicle 10,000 miles in 2002 and 6,000 were for business, then your business to personal ratio is 60/40 of your total vehicle expenses.

Recovering Cost Associated with the Decline in Value or Useful Life of the Asset: When the actual cost method is used to recover the cost of owning and operating a vehicle for business use, tracking most costs simply requires totaling all actual expenses incurred. However, the cost associated with the decline in value and useful life is not as readily determined. The task is made easy, however, using IRS provided tables and by figuring your depreciable "basis" in the asset. Your basis is simply the total cost incurred in acquiring and adapting the asset for productive use in your business. The result is a schedule of the amount of depreciation that you may expense in each year, beginning with the year of purchase until the asset is fully depreciated and the entire cost has been written off against your business income.

There are three types of deductions available today to affect the write-off of the capital expense of a vehicle. These three are Section 179, bonus depreciation and standard depreciation.

Continued on page 13

***Expensing Capital Assets,* continued from page 10**

<u>Bonus Depreciation:</u> In 2002, Bush's tax legislation introduced a first-year bonus depreciation deduction equal to 30 percent of the cost of qualifying new (not used) assets purchased after September 10, 2001. The new 2003 tax law increases this first-year bonus depreciation to 50 percent for the tax years 2003 and 2004.

This 50 percent bonus depreciation applies only to assets purchased on or after May 6, 2003 but before the end of 2004. Unless Congress votes to extend the increased bonus, the bonus depreciation will disappear after the 2004 tax year. There is no limit to the dollar value of capital purchases to which the bonus depreciation allowances may be applied. The 30 percent bonus depreciation still applies for assets purchased from January 1, 2003 to May 5, 2003. In addition, some states have elected not to adopt the federal legislation on bonus depreciation. Be sure to check with your state laws before preparing your state tax return. ❐

Summary of Accelerated Depreciation Opportunities for Capital Expenditures

Section 179

- Section 179 allows a business to expense up to $100,000 of capital expenditures in 2003, 2004 and 2005.
- Section 179 laws do not discriminate between purchases of new and used assets.
- Section 179 expensing allowances are reduced dollar-for-dollar for the amount in which total capital expenditures exceed $400,000 in a particular tax year for 2003, 2004 and 2005.
- Section 179 can only be taken in the year that the capital asset is acquired and ready for use in the business.
- Company vehicles may be expensed via Section 179 as long as they are used at least 50 percent for business purposes. However, if the vehicle does not weigh at least 6,000 lbs., the 179 deductions will be all but eliminated via luxury tax limits.

Bonus Depreciation

- Allows for 50 percent of the depreciable basis (cost of the property less any section 179 expense taken on the asset) of any qualifying asset to be written off in the year of purchase.
- Bonus depreciation may only be taken on purchases of new property (capital assets).
- There is no limit to the amount of annual capital purchases to which the bonus depreciation provisions may be applied.
- Regular depreciation schedules are set-up on any amount that remains unexpensed or undepreciated after 179 or bonus depreciation provisions are applied.
- Fifty percent bonus depreciation may only be taken against assets purchased on or after May 6, 2003 but before the end of 2004. The 30 percent bonus depreciation still applies to assets purchased on January 1, 2003 to May 5, 2003. ❐

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Could You Qualify for the 6,000 lb. Vehicle Rules?

If the following were true, you likely would be able to expense, in the first year of purchase, all or a significant amount of the cost of a new vehicle if it is rated at more than 6,000 lbs.

- ▲ Will more than 50 percent of the miles be driven be for business activities excluding your commute to and from your home?
- ▲ Will your business have a taxable income greater than the cost of the vehicle? ❐

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Written by David L. Perkins, Jr., of *The Business Owner*.

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***Company Vehicle Tax Laws (Section 179, Bonus Depreciation and Other),* continued from page 11**

<u>Section 179:</u> Section 179 of the IRS tax code gives you the option to expense, in the year of purchase, an amount of the purchase "off the top" before any depreciation allowances are calculated or applied. 2003 tax law changes raised the allowance from $25,000 to $100,000 for capital assets purchased in 2003, 2004 and 2005.

It is important to note that a Section 179 deduction can only be claimed in the year that the asset was first available to you for service in your business. For example, you cannot claim a 179 deduction if you used the vehicle for personal purposes for a year or more first and then began using it in your business.

Note as well that a 179 deduction may only be taken on capital assets used more than 50 percent in the business. If this is the case but the business usage is less than 100 percent, you must multiply the percentage of business usage by the total cost of the asset to obtain the amount that is available for a 179 deduction. Furthermore, if you take a 179 deduction on a vehicle and the business usage drops below 50 percent in an ensuing year, you may have to recapture (add back to income) any excess depreciation taken. Similar treatment may occur if you sell the vehicle for more than the adjusted basis for tax purposes (basis = acquisition price minus all depreciation and 179 deductions taken). Talk to your accountant.

<u>Bonus Depreciation Allowance:</u> This IRS provision, originally written into law in 2002, allows for a special, one-time deduction of the depreciable basis in a new capital asset. In addition, there is no dollar amount limit to the amount that may be depreciated under this provision. The 2003 tax law changes increased this amount from 30 percent to 50 percent. The increased amounts apply for tax years 2003 and 2004 only.

The amount of the deduction is figured using the basis of the asset after any 179 deductions have been taken (see above). For example, if you purchased a truck for $40,000 and elected to take a $20,000 179 deduction, the adjusted basis would be $20,000. This adjusted basis is used to calculate any special depreciation allowance. Assuming the taxpayer qualified, $10,000 could be written off under this special depreciation allowance, calculated by multiplying the $20,000 adjusted basis by 50 percent.

Note, however, that some states have elected not to adopt the federal legislation on bonus depreciation. Be sure to check with your state laws before preparing your state tax return.

<u>Regular Depreciation:</u> Depreciation is the method under which the IRS allows a business to recover the cost of

continued on next page

***Company Vehicle Tax Laws (Section 179, Bonus Depreciation and Other),* continued from previous page**

capital assets. A capital asset is any tangible asset that has a useful life that exceeds one year. The IRS lists the useful life of each type of asset, such as a truck or a building, and provides schedules that may be used to calculate the percent of the asset's cost (called a "basis") that may be expensed each year as depreciation.

Regular depreciation is calculated using the basis that is first reduced, or adjusted, for any section 179 and bonus depreciation taken (see above). Automobiles and trucks used for passenger transport are depreciated over five years.

Luxury Tax Limits: Assuming 100 percent business use of your vehicle, the total amount of 179 and depreciation deductions that you may claim for a vehicle that is placed in service between January 1, 2003 and May 5, 2003 is $7,650. For vehicles purchased after May 5, 2003 and before January 1, 2005, the maximum is $10,710. (If the vehicle is *used* and purchased after May 5, the limit is $3,060.)

This provision is referred to as the "luxury tax" as it disallows the expensing, through depreciation, of all but a minimum amount of the capital cost of a vehicle. This cap is further reduced if your business usage is less than 100 percent. However, the luxury tax limit does not apply if your vehicle does not fit the IRS' definition of a passenger automobile, which is:

> *"A passenger automobile is any four-wheeled vehicle, such as an automobile, van, pickup or panel truck, made primarily for use on public streets, roads and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight."* ❒

Should You Take Advantage of the Accelerated Expensing Provisions?

Accelerated expensing options such as Section 179 and bonus depreciation are not mandatory, but elective. So, should you take them even though you are eligible? The answer is not automatically "yes."

To make the determination, keep in mind that you may not really gain any cash by accelerating expenses such as depreciation. The only effect may be timing. Every dollar that you expense today reduces the expense that is available tomorrow to offset income. The result is lower taxable income today and higher taxable income tomorrow. The same goes for income taxes.

But due to the time value of money, we would rather pay taxes later rather than sooner - all things being equal. Therefore, we are inclined to take for today as many deductions as we are able. However, with our graduated tax code, not all things are equal. Income tax rates rise as income increases.

A primary goal of tax planning is to keep income at a level that minimizes the dollars of income that fall into higher, penalizing tax brackets. If taking significant deductions this year would trigger a sizeable income tax burden next year, especially at higher rates, consider saving some deductions to avoid this circumstance. See the 2003 tax rate and income threshold information on the back of the March-April 2003 issue of *The Business Owner*, and talk to your accountant. ❒

"Sacred cows make great steaks."

Richard Nicolosi,
former CEO and Chairman of Samsonite

***Buyer Value and the Value Chain,* continued from page 9**

Buyer's Value Chain

Buyers also have value chains. Your company's product represents a purchased input to your customer's chain. Your differentiation stems from how your own value chain relates to that of your customer. It is a function of the way your physical product is used in the particular customer activity in which it is consumed (e.g., a machine used in the assembly process) as well as all the other points of contact between your business' value chain and your customer's chain.

Differentiation, then, is derived by creating unique value for the customer through your firm's impact on your customer's value chain. Each and every link between your business and your customer can be used to deliver value. However, the links that are most relevant to a particular customer depends on how the supplier's product is actually used by the customer, not necessarily how it is intended to be used.

The Value System

A company's value chain is imbedded in a larger stream of activities that can be referred to as a "value system," as depicted in the accompanying graphic, Figure 3. Suppliers have value chains that create and deliver the purchased inputs used in the customer's value chain. The customer's needs are determined by the customer's own value chain.

Suppliers not only deliver a product but can also influence a customer's performance in many other ways. In addition, a company's products often pass through the value chains of distributors, or resellers (referred to as "channels") on their way to the buyer. Channels perform activities that affect the customer and become a part of the customer's own value chain.

It is the product's role in the end user's value chain that ultimately forms the basis for differentiation. Gaining and sustaining competitive advantage depends on understanding not only a firm's value chain but also how the firm fits in the overall value system.

Linkages

Every business' value chain is composed of nine generic categories of activities. Each of these activities are shown on the accompanying generic value chain graphic (Figure 1) and include firm infrastructure, human resources management, technology development, procurement, inbound logistics, operations, outbound logistics, marketing and sales, and service.

Each activity is linked together in characteristic ways called "linkages." Although value activities are the building blocks of competitive advantage, the value chain is not a collection of independent activities but a system of interdependent activities. Value activities are related by linkages within the value chain.

Linkages are relationships between the ways one value activity is performed and the cost or performance of another. For example, purchasing high quality, precut steel sheets can simplify manufacturing, reduce scrap and improve quality. The ability to coordinate linkages often reduces or enhances differentiation. Better coordination, for example, can reduce the amount of total inventory needed throughout the firm. Identifying linkages is a process of searching for ways in which each value activity can be affected or is affected by others.

To conclude, this article offers a systematic way for the business owner to break apart their business to more accurately understand how they create value. By doing so, the business owner can more clearly identify the activities that are critical for delivering value to the customer. Doing so also makes it easier to spot areas for improvement. Next, this article explains that by better understanding the significant impact that vendors/suppliers and distributors/resellers have via linkages, the business owner can more adeptly coordinate relationships in a manner that helps reduce cost, improve performance, and more fully supports efforts to deliver unique value. Finally, by applying the value chain methodology to our customers, the business owner can pinpoint all the ways that their firm affects the customer - directly and indirectly. Each area offers opportunity to more fully support the customer's value-add proposition to their customer. ❒

This article is the sixth in a series that presents the state of the art in competitive theory. The basis of this article, and the series, is the work by a Michael E. Porter. His two primary works are 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 Differentiation as a Path for Superior Profits (2003 Mar/Apr Issue)

Part 4: Cost Drivers and Where to Look to Lower Cost (2003 May/June issue)

Part 5: Customer Perception and Signaling (2003 July/Aug issue)

> Part 6: Buyer Value and The Value Chain (This issue of The Business Owner*)*

Part 7: Switching Costs and Substitution (2003 Nov/Dec issue)

***Figure 3.** The Value System*

$cam Alert

International Profit Associates

During a scheduled break of a presentation by the author of this publication to the members of the International Sign Associates, a businessman by the name of Elvis Davis inquired about a company called International Profit Associates (IPA). The topic of discussion was businesses and business people that prey on the hopes, dreams and (at times) the desperation of small businessmen and women. He explained that IPA had called on him and eventually convinced him that the company could help him become more profitable and pay lower taxes. He agreed to engage the company on an hourly basis, with a total cost estimate of somewhere around $11,000. In short, the bill became $35,000 and the results were far worse than useless. The damage to the company morale, productivity and bank account took years to correct. In hind site, he thinks it was simply a scam.

The IPA name was familiar, as *Inc.* Magazine had printed an incredible article featuring IPA in their January 2000 issue. The author, Joe Rosenbloom, reported that he wrote the article after receiving complaints from *Inc.* readers about the company and tactics used. The article went on to report that a disbarred lawyer named John Burgess, a former George S. May employee sporting an attempted grand larceny conviction, owns IPA. His two founding partners also have criminal records.

According to the article, IPA was founded in 1991 and posted 2001 revenue of $105 million. With an average client fee of $18,000 (an amount offered by Mr. Burgess), approximately 6,000 small business clients were served in that year. Although they purport to be a consulting company, only 20 percent of the employees are consultants, the majority being telemarketers and sales people. In researching the story, Rosenbloom had no trouble finding disgruntled clients through Better Business Bureau complaint filings.

According to the article, IPA relies heavily on:

- A massive telemarketing force and very aggressive sales tactics.
- Usage of credibility garnering "signals" such as paying for high-profile spokespersons and IPA's inclusion in Inc.'s list of fast growing companies.
- Dodging requests for references by explaining that their clients want their names to be kept confidential.

Here are some other quotes:

"Having worked there (IPA) for 60 days and participated in the unethical hard core sales pitch, my only remorse is for the two clients whom I convinced to part with a lot of money for no value."
Walt Marino - Orlando, Florida

"I signed their pressured deal. At the time it all made sense. Now I realize the huge mistake I made."
Tim Shea - Escondido, California

"Once the sale was made, a very unqualified person came in to do the work. Nothing went well."
Elvis Davis, Memphis Tennessee

"I recently spent one week in Chicago training to be an IPA senior advisor. After seeing firsthand their sales tactics (very heavy handed, strong arm, aggressive techniques), coupled with the old bait & switch approach, I have decided to pass on this opportunity."
Bob Thompson, Detroit, Michigan ❒

> **"Business is a big experimentation – one big ongoing experimentation – when it really comes down to it."**
>
> *Andy Grove,*
> *CEO of Intel Corp.*

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