

# The Business Owner<sup>®</sup>

## Capital Sources: Internal, Trade, Debt and Equity

You need money to advertise, market, sell, stock inventory, pay employees, extend trade credit, rent a facility, purchase equipment, pay taxes, etc., etc. And nothing soaks up cash like success (i.e. sales growth). So, you search for money. Take caution, however. All money is not the same. Fail to appropriately match financing need with type and you'll risk losing profit, time, credibility, or worse.

This article explains the various types of capital and the appropriate uses of each. Enhance your understanding of types and uses and you will be a better manager and business owner. It will certainly save you time and money. It could even save your business.

### Money or Capital?

For some reason, many business people don't like to use the word "money." It's gauche, so the word "capital" is often used instead. From a textbook perspective, "capital" refers to money, labor, raw materials and other "factors of production." Regardless, when people use the word "capital" today they typically mean "money." In this article we will use the terms money, cash and capital synonymously.

### Short-Term and Long-Term

Capital can be classified as either short-term or long-term. Short-term is less than one year. A common short-term need is seasonal increases in "working capital"—the money tied up in the balance between the working accounts (receivables, inventory and accounts payable). Working accounts turn over quickly. Take for example, a seasonal business that needs money to buy and build inventory in anticipation of the busy season. The loan is short term and should be paid off when sales are turned into cash. Another example is the contractor that needs money to fund work-in-process until projects can be completed, billed and collected. Long-term is more than a year. Long-term financing is used to fund the purchase of assets that generate value for more than a year, such as property and equipment. Long-term financing can be debt or equity, and may be appropriate to fund permanent (non-seasonal) increases in working capital.

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# From The Editor

Dear Business Owner:

How much time do you spend each week working on or worrying about paying your bills? For many it's a paralyzing drain on focus and productivity. Clearly, profit and ... more accurately ... cash flow is the lifeblood of a business. Our future is only secure when profits are consistently earned and retained.

There are two ways to increase profit:

1. Raise Revenue
2. Lower Expense



David L. Perkins, Jr.

Every business owner teaches his or her team to vigilantly wring out expense. Reductions in recurring expenses will often yield the greatest result. Read the enclosed articles on merchant payment services (credit, debit and check cards, etc.) and how to reduce this expense. It's a little complex, but once you understand it you'll be in a position to negotiate much more effectively and get more for your money.

Financial problems may also arise when we inappropriately fund capital needs. In other words, every business needs capital, but it is critical to match the need with the type/source. The feature article in this issue is *Capital Sources: Internal, Trade, Debt and Equity*. Read it and become a better manager. It will make your life easier. It might even save your business.

Next, we all strive for productivity and effectiveness. We also want quality of life. Health and wellness are the vital link to both. For this reason business owners must become more knowledgeable on how to maintain our well being. And so, we welcome Andy Core to our Editorial Advisory Board. Mr. Core is an expert on fitness, health, wellness and in this issue he begins sharing his know-how with you via a regular column. Be sure to read *The Performance Trap* on page twelve.

You'll also find herein some helpful tax-related articles. Past issues have dealt extensively with tax minimization strategies, so we chose not to repeat those again in this issue. Try to get your taxes filed on time (avoid the extension), so you can devote the rest of 2005 to the substantial evolution that you envision.

Sincerely,

David L. Perkins, Jr.  
Publisher and Editor

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**INVESTMENT / VALUATION**

# ***Case Study*** **Valuing a New Venture and Minority Interest**

The majority owner of a business was presented with a new business opportunity that was not exactly related to that of his core business. He had lots of questions and asked for our help. This case study will walk you through the simple analysis that we facilitated.

The Case: Tim Frame owns eighty percent of Frame Services, Inc., a business that provides medical billing for doctors' offices. Scott Hope owns 20 percent. Through a personal relationship, Tim has been presented with an opportunity to provide pension administration and actuarial services for a large insurance company. The proposed contract is for four years and will pay \$350,000 per year. There are also circumstances that make it extremely unlikely that the contract will extend beyond the four-year term.

Tim wants to set this contract up separate from Frame Service, Inc. and he wants to own 100 percent of it. So, Tim turns to us for assistance.

*Question 1: Does Scott have a right to 20 percent of the new venture or not? What are the issues here? In other words, does Scott need to be bought out at all?*

*Answer:* This may be more of what we call a soft issue, meaning it has more to do with the relationship between Tim and Scott than a legal issue. What is the understanding between Tim and Scott?

We must also "drill down" into how this opportunity really arose. Meaning, from where did this "personal" relationship come. Did it develop through the business of Frame Services? Sure, the new opportunity is a service not performed by Frame Services, but carving it out into a new entity or venture and excluding Scott from ownership might not sit well with Scott. It could create problems between Tim and Scott. It could even lead to a lawsuit.

Following lengthy discussions, we agreed that Scott should be considered a 20 percent owner in the to-be-established venture.

*Question 2: What is the net cash that will be received from the project?*

*Answer:* The agreement will pay \$1,400,000 in four equal payments to be received at the end of each of the first four years. Tim explains that this is the NET cash he estimates from the project. In other words, he estimated the annual cost of the project and subtracted them from estimated annual revenue to arrive at \$350,000 in net cash per year.

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**“The way to achieve success is first to have a definite, clear, practical idea – a goal, an objective. Second, have the necessary means to achieve your ends – wisdom, money, materials and methods. Third, adjust all other means to that end.”**

*Aristotle*

# Marketing for Dummies? Build in Quality Control

Marketing is the careful orchestration of initiatives aimed at building awareness that you exist, of what it is you do, and who should come to you for help.

As the art and science of marketing has evolved to incredible levels of sophistication, the power and importance of two things has been indisputably revealed:

1. Distinctiveness
2. Consistency

Distinctiveness means you have uniqueness. You are one-of-a-kind. Prospects want to know who you are and for what you stand. They want you to have a distinctive personality. But the term “personality” is what we use for individuals. We call it a “brand” when it’s a business.

Consistency simply means prospects want you to exhibit your personality in everything you do. Once prospects develop a feel for who you are and what you stand, they want you to exhibit those qualities every time.

The simplest way to choose a brand is to descriptively identify the personality of you, the owner, and of the business. Are you “Mr. Details,” “Mr. Fun” or “Mr. Find a Way”? When you offer something distinctive, prospects will be able to quickly and easily ascertain the circumstance or need for which they should select you. If it’s a challenging project they want delivered, they’ll go for “Mr. Find a Way”. If the prospect’s paramount concern is accuracy and thoroughness, they’ll go for “Mr. Details”.

Unfortunately, the painful truth is that consistency is a real challenge. Only the very best businesses master the consistency imperative. After all, you have multiple people representing you, designing materials and making promises. It’s natural that each employee has a different style, aptitudes, priorities and personality. But given the importance of consistency we have to find a way to deliver it if we are going to succeed.

The foundation of any branding strategy is clear identification of the brand. Next, all people in your organization must clearly understand the “personality” of your company. They must understand who you are as a group, for what you stand, how you are different from your competitors and how these

characteristics will be woven into every product, service, policy, marketing piece, tag line and customer contact. Your people must become your brand personified. You can do this through the following four initiatives.

## **Identify Your Company’s Core Brand Elements**

Every company has the opportunity to make a strong brand statement via a novel policy communicated with gusto, such as FedEx’s “When it absolutely positively needs to be there over night” or Burger King’s “Have it your way”. Clearly, FedEx’s employees need to both understand the promise and deliver on the promise. How would a customer react if she asked for “extra pickles” and the Burger King employee said “we can’t do that”?

Every business should attempt to find a few core brand elements that sets them apart from the competition and helps build their identity. Then, every employee must understand, adopt and deliver on the policy.

## **Brand Role Models, Hiring and Employee Training**

Employees begin to assimilate the company brand when they see it in action ... lived and delivered by the owners and managers. The owner sets the tone by personally demonstrating the brand – consistently and to perfection.

The hiring process should include an explanation of the brand. Employee candidates should understand the brand and be comfortable with it ... if not passionate.

Employees need formal brand training. Take time to periodically meet to discuss the brand, the importance of distinctiveness and consistency, and the various means for delivering on the brand promise. Each employee must understand how their moment by moment behavior IS the company image. Every behavior needs to be compatible with the group’s core values.

For example, if your company takes the “total satisfaction” position, employees must be willing and able to make it so. In contrast, if your company promises to offer the lower cost products anywhere, it must be so. In this case, customers might not expect the greatest facilities or service, as long as you deliver on your low cost promise. Your employees also need to have a grasp of these trade-offs. They need to know that the only way to be able to deliver on the low cost promise is to run the business on minimal cost. In this way, the chosen brand goes beyond the customer and impacts the entire business model of the company.

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**You build in quality to control. You create systems and processes that build in quality and consistency from prospect inquiry through the post-purchase feedback.**

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Password for March 1 through April 30: **Value**

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## Scripts and Tag Lines

For what you stand should be communicated regularly and consistently. One way is how the phone is answered. Consider having your phones answered in the same manner each time, possibly with a phrase that communicates for what you stand. Ditto with email.

Customer service representatives should be given a clear set of messages and well-defined procedures for how to handle specific situations. Scripts, if you will, for both incoming and outgoing telemarketing that ensures the delivery of a consistent message.

Every customer complaint should be logged and periodically reviewed for clues to weak links in the brand delivery program.

Be cognizant of explicit and implicit messages. Explicit messages are those actually written or spoken. Implicit messages are delivered in context, presentation or behavior. For example, you may be saying, "I'm happy to serve you" but your body language or tone may convey otherwise.

Finally, don't overlook far afield ways your brand may be shaped, bolstered or damaged. For example, how your employees represent you at a technical conference or training school.

## Print and/or Creative Materials

With the ubiquitous nature of desktop publishing and the "do-it-yourself" nature of business communications today, the information your prospects are receiving is likely being created by a wide smattering of your employees. It is also likely that few have received basic training in effective design or writing.

Establish quality templates to use as an organization. Train your people on their use. Make them available on everyone's desktop. You'll drastically improve consistency and probably reduce time and cost.

## Building in Quality Control

As you build in quality control, it's vital that you regularly monitor and adjust. You must assess, obtain feedback, and hold your people accountable. For example:

- Require that every created piece be reviewed by a "brand officer".
- Provide every new employee with a "brand mentor."
- Utilize "secret shoppers" – persons that contact your company and pretend to be a prospect or customer and then provide you with an objective assessment of how they are treated.
- Randomly talk to employees to check understanding of the brand promise and the various ways it is implemented.



- Develop a culture that welcomes and celebrates ideas for effectively implementing and protecting the brand promise.

When it gets down to it, people are not very complex. Reward a behavior and it is likely to be repeated. So, visibly recognize behaviors that are consistent with the brand promise that you adopt. Create and bestow awards. Give little gifts of recognition. Include brand championship as one of the criteria on which employee performance is evaluated. Similarly, reprimand employees that fall short of or damage the brand.

By solidly establishing your company brand and building in quality control, consistency in delivery is possible. Do this well and you will be in rare and successful company.

This article is the sixth of a nine-part article series on branding called *The ABC's of Small Business Marketing*.

May-June '04 Issue: *Your Marketing Message*: Back to the Drawing Board

July-August '04: *Avoid Marketing Mayhem*: Establishing Your Brand Vision

Sept-Oct '04 Issue: *Logo and Look*: Selecting the Visual Elements that Support Your Brand Vision

Nov-Dec '04 Issue: *Tag Lines and Messages*: What You Say Should Support Your Brand Vision

Jan-Feb '05: *Guided Missile Marketing*: Selecting Means with Maximum Payload

>This Issue: *Marketing for Dummies?* Build in Quality Control

May-June '05 Issue: *Master Your Marketing*: Monitoring and Feedback Enable Continuous Improvement

July-Aug '05 Issue: *Creative Creatures*: Working with Marketing, PR and Ad Professionals

Sept-Oct '05 Issue: *Win the Marketing Game*: Be Proactive or Perish

Jean Wilcox and Jane Cameron contributed their expertise to this article series. They are partners of *CattleLogos Brand Management Systems, LLC* and co-authors of *Abullard's ABC's of Branding*.

**"We just ask ourselves: Is it different?  
Is it distinctive? Is it good?"**

*Chris Albrecht, President of HBO Original Programming*

# Business Valuation Basics: Four Key Questions

Business valuation can be complex. But as with most projects ... a good start is to build a solid foundation. The foundation of a good appraisal will be the answers to four simple questions:

**Value What?** The first step is to clearly define what is being valued. If the subject of the appraisal is a going concern (an ongoing operating business), then it is the income stream of the business that is being valued.

A business is nothing more than a group of assets – people, ideas, processes, products, equipment, etc. – that produce an income stream. To the extent there are assets not necessary for the generation of the profit stream, these assets should be excluded from the appraisal. If there are assets not actually owned by the business but necessary for the generation of the profit stream, then these assets need to be contributed to the business by the owner or the cost of acquiring the assets must be subtracted from the value.

It must also be determined whether the appraisal is of the assets or the equity of the business. An appraisal of the assets assumes the seller would retain all non-working/non-interest bearing liabilities of the business and, in a hypothetical sale, pay them off with funds received from the purchaser of the business. If the equity of the business is being valued, it is assumed the hypothetical buyer would get ALL assets of the business and assume ALL liabilities as well. This should not be confused with HOW the business is purchased as in the legal question of whether it is an asset purchase or stock purchase.

**Value to Whom?** The answer can be an individual, investment group or another company. Once this question is answered, all the factors contributing to or detracting from the value of the subject business for the particular buyer must be considered. This type of value is referred to as *investment value*.

*Example:* To determine the value of XYZ Company for Mr. Tenor, we need to consider all the objective and subjective characteristics of XYZ Company as they relate to Mr. Tenor and his own particular assets, interests, situation, capabilities, fears, etc. Mr. Tenor may have a lifelong dream of owning XYZ Company and may have a particular aptitude that would allow him to place substantial value on the business. On the other hand, Mr. Tenor may see ownership of XYZ as a burden he has no interest in bearing at any price.

**What Definition of Value?** The value definition explained above is *investment value*. An alternate value definition is *fair market value*. To explain, Mr. Seller may only be willing to sell his business if he is offered more than the value that it has to HIM. This is simply the investment value to Mr. Seller. However, Mr. Seller may want to simply receive “as much as I can get.”

Selling a business for maximum value can be a very frustrating task. First, what is the maximum value of a business? The reality is nobody knows. How will Mr. Seller ever know if a particular offer he receives is the highest obtainable? Even if the price is the highest obtainable today, what about tomorrow?

Business sellers enter into a very confusing and frustrating dilemma when the goal is value maximization. Add the possibility that the maximum value might include some seller financing. Mr. Seller must then consider, assuming the buyer's ability to pay will to some degree come from future profits of the business, whether the buyer will be able to run the business successfully. Faced with the “what is maximum value” dilemma, many sellers decide to go for *fair market value*.

## Fair Market Value

*The price at which an asset would change hands between a willing buyer and willing seller, both of whom are reasonably knowledgeable of the pertinent facts and neither under any compulsion to act.*

The technical process for estimating *fair market value* can be quite complex. However, the

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## About the Publisher

David L. Perkins, Jr. owns, writes, edits and publishes *The Business Owner*, the newsletter of choice for more than 25,000 business owner subscribers that are serious about building wealth through successful private business ownership.

Mr. Perkins draws editorial ideas and inspiration from his daily work as a merger and acquisitions consultant, where he has advised on more than 100 purchase/sale transactions involving both private and public companies. His M&A consulting firm is Vercor, which has six U.S. offices and a European affiliate office. Vercor specializes in self-side representation of businesses valued between \$2 million and \$75 million (see [www.VercorAdvisor.com](http://www.VercorAdvisor.com)).

Mr. Perkins holds a Bachelor of Psychology degree from the University of Oklahoma and a Master in Business Administration degree from the University of Notre Dame. He has formal training in business valuation, was awarded the Certified Business Intermediary designation in 1998, and is a licensed real estate broker. He also editorially pulls from prior experience in commercial real estate leasing and brokerage, commercial bank lending and private company financial management.

David L. Perkins, Jr. is the author of [A Concise Overview of Business Valuation](#) and co-author of [The Business Sale, An Owner's Most Perilous Expedition](#). Both may be purchased at [www.TheBusinessOwner.com](http://www.TheBusinessOwner.com).

Mr. Perkins is a professionally trained, content-rich platform speaker available for both keynote and breakout sessions. In-demand topics include “Business Valuation is for You, Today. Wait ‘til You Want to Sell and It’ll Be Too Late”; “If Cash Is King, Why Isn’t the Statement of Cash Flows?”; “Go or Grow. Today’s Environment is Not for the Uncommitted”; and “Business Exiting for Dummies”.

David L. Perkins, Jr. and his staff stand ready to serve you and yours in the following areas:

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Call 800-634-0605 or email [David@DavidLPerkinsJr.com](mailto:David@DavidLPerkinsJr.com).

## Case Study: Valuing a New Venture and Minority Interest, continued from page 3

Tim did not estimate income taxes, however, so in talking to Tim and his accountant we estimate the annual taxable income to also be \$350,000. We established a tax rate of 30 percent (state and federal), yielding after-tax cash of \$245,000 per year [ $\$350,000 \times (1 - \text{tax rate})$ ].

*Question 3: What is the value of the new opportunity? Tim should get a handle on this before he ever accepts the project regardless of the situation with Scott.*

*Answer:* The value of the opportunity is based on the net cash that will be derived from it. However, a dollar held today is more valuable than a dollar received in the future. Why? Two big reasons. One – a dollar held today can be invested to earn more money. Two – risk that the dollar will never be received. After all, what if the person that is supposed to pay the dollar fails to do so?

So, to compare apples to apples, we value all things in terms of present value (i.e. dollars today). Doing so allows us to directly compare the value of, say, \$100 today – \$200 paid over the next three years and \$1,000 over the next 15 years.

Tim's opportunity promises annual after tax cash of \$245,000 over four years, but there is no guarantee. For starters, the proposed agreement states that Tim's customer will be obligated to pay only "as long as the services are provided in a satisfactory manner." Sounds like something that could be open to interpretation and potentially provide the customer with an "out."

Aside from this, the company is large but it will not provide information about its financial condition. We pulled a Dun and Bradstreet (D&B) report on the company and found no cause for concern, but D&B is not always up to date, and even the most seemingly stable business can run into problems, e.g. Enron and WorldCom.

In summary, to compensate for the time value of money and risk (combined), we chose a discount rate of 20 percent. As such, we "discount" at 20 percent per year the payments expected to be received in the future. Here is the calculation:

Year	Net Cash Flow	X	PV Factor 20% Rate*	Value Today
1	\$245,000		.833	\$204,085
2	\$245,000		.694	170,030
3	\$245,000		.579	141,855
4	\$245,000		.482	<u>118,090</u>
			Total Value	<u>\$634,060</u>

*Note:* Discount factor rates are found in the backs of most finance textbooks, on the Internet, and are included in [A Concise Overview of Business Valuation](#) (see [www.TheBusinessOwner.com](http://www.TheBusinessOwner.com))

In summary, we estimate the project to be worth \$634,060.

*Question 4: If Scott has a right to 20 percent of the new venture and Tim wants to buy him out, what would be a fair price?*

*Answer:* Now that we have estimated the value of the entire project, we're within reach of placing a fair value on Scott's 20

percent interest. Clearly, we could simply multiply \$634,060 times 20 percent to obtain \$126,812. One could argue compellingly that this is the value of Scott's share. However, one could also argue that Scott is in a very weak position to bargain because his ownership interest is too small to really influence the business or dictate when and if profits are distributed. Also, Tim is really the only buyer for Scott's shares. Legally, Tim could choose to not distribute profit to shareholders, not to employ Scott, and not to buy Scott's interest. For reasons such as this, minority interests trade at a discount.

Value of 20% Ownership Position	
Value of 100%	\$634,060
Times 20% Minority Ownership	<u>.20</u>
	\$126,812
Less Minority Discount @ 35%	<u>0.65</u>
Net Value of 20%	<u>\$ 82,428</u>

In conclusion, we suggest that Tim use \$126,812 as the maximum he would be willing to pay for Scott's 20 percent of the new venture. A 35 percent minority discount would also be fair, placing the value at \$82,428. □

## Coming Up in *The Business Owner*

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<b>Business Plan Made Simple</b>	<b>Don't Get Sued When Trying to Collect</b>
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<b>Compelling Reasons for Getting Your Family Involved in Your Business</b>	<b>How to Steer Clear of Sexual Harassment Claims</b>
■	■
<b>Avoid This Credibility Killer</b>	<b>Outsourcing: A Powerful Tool for Productivity</b>
■	■
<b>Age Discrimination Laws</b>	<b>When to Hire an Agent or Representative: The Science is Clear!</b>
■	■
<b>Appraisals: Getting More for Less</b>	<b>Monitoring and Feedback Enable Continuous Improvement</b>
■	■
<b>Estate Planning – An Overview</b>	<b>Signals to Write a New Will</b>
■	■
<b>Steering Clear of Sexual Harassment Claims</b>	<b>The Right Way to Select an Executor/Executrix</b>

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

# Payment Card Services Program

## Manage the Costs Regularly and Carefully

Most businesses accept electronic forms of payment – debit cards, credit cards, check cards, PayPal, gift cards, etc. Why? Customers want to pay with them, so it's good business from a customer service standpoint. It's good business for several other reasons as well.

**Purchase Power.** Accepting alternate forms of payment expands the customer's ability to purchase. The result? Customers buy more. More frequently and higher amounts per purchase.

**Collection Certainty.** Electronic payment systems enable instant verification of customer credit, and once a transaction is approved by the merchant card service provider, collection risk switches from merchant to processor. In other words, the merchant is guaranteed payment minus a small fee. Compare this to trade credit (i.e. net terms), which leaves the merchant exposed to collection risk and (for many companies) higher costs.

It can be said with conviction that sales via trade credit "terms" is inferior to electronic forms of payment such as credit cards in the following ways:

- a. **Credit Check:** Providers of merchant payment processing systems have mastered the point-of-sale credit check process. It's instantaneous and accurate. Other dominant credit check methods such as those provided by Dunn and Bradstreet remain slow, expensive and inexact relative to the process provided by merchant payment processing companies.
- b. **Collection Cost:** Trade credit usually requires printing and mailing of an invoice, progress billing and then manual processing of the payment once it is received. The labor required is costly. In contrast, electronic payment methods such as credit cards require no post transaction labor except monthly statement reconciling.
- c. **Collection Risk:** Trade credit "terms" leave the merchant exposed to the risk that the customer will not pay for what he or she purchased. Electronic payments such as credit and debit cards shift collection risk to the processor.

**Cash Flow Acceleration.** A substantial benefit of collecting payment via credit card, debit card, check card, etc., is that sales proceeds are rapidly received. Proceeds from sales via credit, debit and check card are automatically deposited into the merchant's checking account within 24 hours. Trade credit is collected in 45 days, on average. Accelerated collection can be nothing less than life giving for companies who are growing and suffering characteristic cash flow strain.

Of course, every payment method has its own set of costs and risks. Cash sales require costs of deposit processing and the risks of pilferage and theft. Trade credit was discussed above. Credit, debit and check cards require equipment and an agreement with a processor – both of which cost money.

No matter how you accept payment for your goods or services, costs will quickly get out of hand unless they are professionally and competently managed on a regular basis. After all, a fool and his money will soon part.

This issue of *The Business Owner* contains nine articles that will help you become more knowledgeable in the area of merchant payment processing services. Read, study and begin getting the most for your money. After all, the only way to make a profit today is to get tough with each expense component of your business. The good news is there are many providers of merchant services and they are willing to compete for your business. □

*The following merchant service professionals generously contributed their time and expertise to the electronic payment/merchant credit card articles in this issue:*

*Dave Miley, an independent merchant level salesperson (MLS) based in Tulsa, Oklahoma. He works with small and mid-size companies in establishing optimal merchant service arrangements. He can be reached at dmiley2@cox.net.*

*Steve Norell, president of US Merchant Service, a merchant level sales organization (MLS) that specializes in merchant card processing programs for multi-unit retail organizations, franchises and associations. Mr. Norell is also president of the National Association of Payment Professionals. He can be reached at steven@usmsllc.com.*

*Mark Dunn, general manager of sales for Optimal Payment Corp., an independent sales organization (ISO). Mr. Dunn is also president of the Midwest Acquirers Association. He can be reached at Mark.Dunn@OptimalPayments.com.*

## Accepting Credit Cards at Your Website

If you are doing business on the worldwide web and need to accept payments, there is no change in how the credit card system works ... you just need a means for capturing the credit card information and submitting it to your processor. Obviously, your customer won't be able to swipe his or her own card or provide it to you physically, so he or she will simply enter the credit card data. You have security issues that you will need to discuss with a person experienced in web-payment issues and technology, and you will want to decide whether the data will come to you and then you will manually submit the order information to your processor, or whether you want to incur the expense of equipping your site with the capability of automatically submitting orders to the processor for approval and payment. Talk to the person that designs your website as well as your processor. □

## Finding the Ideal Merchant Credit Card Processor

To find a top-notch merchant card processing company, start by identifying an “A” list of candidates. Begin by locating providers that are being used with satisfaction by persons that you know. Another easy choice is that of a well-known and reputable company. In addition, here are other possibilities you should consider.

**Your Accounting Software:** Investigate whether your accounting software offers an integrated merchant credit card solution. The leading small business software packages, such as QuickBooks and Peachtree, certainly do. The integration with your accounting software may save considerable data entry time.

**Your Trade Association:** Trade associations are a valuable source for member benefits. They will often use the collective clout of their members to negotiate an attractive merchant credit card plan. Find out if your trade association has preferred merchant processors or independent sale

organizations (ISO).

**Your Peers:** The best vendor is often one that is accustomed to the unique needs of businesses like yours. Talk to your peers, preferably ones in your geographic area. Find out who they use and if they are satisfied.

**Your Bank:** Whether or not your bank issues credit cards, they will likely be able to suggest a reputable merchant card processing company or independent sales organization (ISO). Call your trusted banker.

Once you’ve obtained candidates, use the following qualifying criteria to select the right processor for you.

1. **Competitive Rates and Terms:** Estimate monthly credit card activity (# of transactions and total dollars per month) and then estimate the cost you will incur under each processor’s plan. Then, weigh the value of flexibility (contract length) and any associated cancellation penalties.
2. **Hardware and Software:** Some processors today will provide you

with the software and hardware that you need if you agree to sign up with them. Regardless, check any and all costs associated with the hardware and software.

3. **Services:** Dependability, speed and ease of use are as important as cost given the cost of labor and customer demand for checkout speed. Other popular services today include the ability to access and review statements online, ability to accept checks and gift cards on the same system as credit cards, and integration with one’s accounting system.
4. **Immediate Trouble Assistance:** Many companies, such as retailers, depend heavily on their ability to accept on-demand payment via credit card. If the system goes down, you want a company that provides “at the ready” assistance 24/7 by telephone and in person at your business if needed. Inquire and check local references. □

## Getting Set-up to Accept Credit, Debit and Check Cards

To accept credit cards, debit cards, check cards and gift cards, all you need is a relationship with a merchant transaction processing company (a.k.a. merchant services provider), and a means for collecting customer card information and submitting it to your processor.

First, identify which type of collection means is necessary for your business. To collect customer credit card information you can purchase, lease, rent and sometimes obtain a loaned terminal at no charge. A credit card terminal is the little machine in which a credit card is “swiped” at the point of sale. It can be a stand-alone machine or connected to your computer or cash register.

If your sales are made over the phone or via mail, you will simply need software that allows the information to be entered manually or a phone number to call to submit the information to your processor.

If you take orders via your website you need your processor or website design company to provide the secure gateway allowing customers to enter their own data. For tips on locating an ideal processor for you, see “Finding the Ideal Merchant Credit Card Processor” above. □

## Where Do Your Merchant Account Fees Go?

Merchants pay a variety of fees for the ability to accept credit, debit and gift cards as payment from customers. The overall cost is typically between two percent and four percent of charged transactions. Here is who actually receives the fees paid by you, the merchant:

- The card issuer (issuing bank, Amex, Discover or Diners Club): approximately 85%
- Credit card association or company (Visa, MasterCard, Amex, Discover or Diners Club): under 10%
- Processor: under 5%
- Merchant Sales Organization: under 5% □

**“In the world today, there's plenty of technology, entrepreneurs and money. What's in short supply are great teams. Your biggest challenge will be building a great team.”**

*John Doerr, Partner,  
Kleiner Perkins Caulfield & Byers*

## Players Behind Payment Card and Merchant Card Systems

**Merchant:** An organization, such as your business, which sells a product or service and accepts customer payment via credit card. For the ability to accept credit cards as payment, merchants pay between two and four percent of the total cost of the sale when all the costs are considered.

**Credit Card Association or Company:** There are just five major credit card programs: Visa, MasterCard, American Express (a.k.a. Amex), Discover and Diners Club. Visa and MasterCard are actually associations whose members are banks who, through membership, gain access to the card program and thereby issue credit cards of the Visa or MasterCard type. American Express, Discover and Diners Club are companies (not associations) and they issue their own credit cards (i.e. they're not issued by banks). However, Amex has recently begun offering a program to banks ... so you may begin seeing Amex Cards issued by a bank.

**Merchant Processor:** When you, as a business (i.e. merchant), sign a merchant service agreement, you enter into the agreement with a merchant service processor. The processor is the company who analyzes the information captured from the customer credit card, checks the validity of the card account, issues approval or denial of the requested transaction, processes the transaction, collects from the credit card holder's bank, deposits the money in the merchant's account, assesses and distributes the appropriate fees, and issues a monthly statement to the merchant. Once a transaction is approved, the processor bears the payment risk. There are only a few processors and they are very large companies including First Data, Global Payments, Vital and Paymentech.

**Independent Sales Organization (ISO):** Processors often utilize independent representatives to acquire merchant accounts. Large organizations that gather merchant accounts for processors are referred to as independent sales organizations (ISO) or merchant level sales organization (MLSOs). ISOs may in turn hire independent sales reps referred to individually as merchant level salesmen (MLS). The difference between a MLS and a MLSO is the former is usually a one-man organization and the latter is made up of many MLSs. ISOs and MLSs make money through application fees and set-up fees (when the agreement is signed), equipment sales and leases, and through residuals generated by transactions run on the merchant account established through the efforts of the ISO. □



## Avoid Costly Merchant Card Service Traps

Take your time and do whatever you must to fully understand the terms of each provider. Beware of hidden costs that lurk in the small print. Compare and contrast competing bids. Take special heed of the following:

- **Price and Terms:** Price is meaningless until you know the terms. Be skeptical of a salesman's claim that he can save you money. Get the facts. If you can't get clear and understandable answers to your questions you have cause for doubt.
- **Agreement Length:** Service agreements will require a minimum contract length. Keep in mind that things always change and prices tend to decline over time. Resist the temptation to commit to a long-term contract for what you believe are favorable terms.
- **Early Termination Penalty:** Find out what the penalties are for early termination. Don't agree to anything that sounds unreasonable.
- **Who You Pay:** Never make payments to an individual. The check should be written to a business name, not a personal name. If your merchant services representative requests that you do so, terminate the relationship.
- **Get a Copy Upon Signing:** Unscrupulous companies that bury onerous terms in the small print will characteristically avoid providing you with a copy of the agreement in an attempt to make sure you don't "get wise." Don't do business with an organization that offers to "mail your copy to you in the next few days." Get a copy of what you sign, right when you sign it.
- **Insurance:** Don't purchase insurance that replaces your terminal if it fails. It is rare that such equipment fails and you can likely get your processor to donate the equipment if you use their service. If you buy or lease equipment, make sure it comes with a warranty. Most merchants believe they are under warranty as long as they are leasing. This is not the case. Most equipment manufacturers guarantee the equipment for a maximum of one year.
- **Equipment Leases:** Credit card terminals are universal today and can be purchased new for between \$300 and \$600. Keep this in mind when you are offered a lease. A four-year terminal lease at \$45 per month will cost you \$2,450 over the term – not a good deal.

Merchant processing fees can add up. As long as you own a business you will be paying these bills, so it makes sense to invest the time necessary to educate yourself on how credit card acceptance works, who are the players and from where the costs come. Review your monthly bills for accuracy, get competitive bids every few years, and make sure that you are perpetually getting the most for your money. This may be the only way to make a profit today – continually ratcheting down overhead expenses. □

## You Want to Pay Us With What?

**Credit Cards:** A credit card is a revolving line of credit extended by a bank or credit card company to an individual or organization. The borrower advances on the credit line by “paying” for products or services, at the point of purchase, using the card. The dominant credit cards programs in the U.S. are Visa and MasterCard, followed by American Express (“Amex”) and Discover. To accept payment via credit card, a merchant must establish an account with a processor of credit card transactions. Then, the merchant will incur charges according to the agreement made with the processor, typically a monthly flat fee, a flat fee per transaction, and a percent of each purchase.

**Debit Cards:** A debit card allows the customer to pay for purchases with funds that are in their checking or savings account. The debit card is swiped into the merchant’s card terminal and then the customer enters a secure personal identification number (pin). The processor verifies that the funds are available in the account, approves the transaction, and then charges the merchant a flat fee of, say, 55 cents (no discount fee/percentage of the transaction).

**Check Card:** This type of card may be used by its holder as either a debit card or credit card. If at the point-of-purchase the customer chooses to use it as a credit card, the merchant is charged fees accordingly . . . just as if it was a regular Visa or MasterCard. If the customer chooses to use it as a debit card, the merchant will incur debit-card fees

(i.e. no discount fee, just a flat fee for the transaction).

**PayPal:** The worldwide web has brought buyers and sellers together like never before; many who buy or sell in very small volumes. The most common means is eBay. The typical merchant credit card service account is not economical at very low volumes, so PayPal stepped in to fill the need. The micro-merchant signs up with PayPal, customers of the micro-merchant pay PayPal for the goods, and then PayPal deposits the money into the checking account of the micro-merchant.

*Note:* PayPal is owned by eBay.

**Gift Cards:** Want a gift idea for someone special? How about a gift card from the local coffee shop, bookstore, movie theatre or restaurant? Your friend will appreciate it. The establishment will appreciate it even more. Why? They make big bucks on gift card sales. First, the merchant is paid well in advance of having to provide any product or service. Second, some cards will never be redeemed; most only partially redeemed. Ah, the most perfect sale ever conceived.

Steve Norell, president of US Merchant Service, says Starbucks has sold 20 million \$25 gift cards. They estimate that \$12 remains unused on each card, on average. That’s \$240 million in revenue with no service delivered. Not bad, especially since most gift cards are programmed to “lose their value” after a certain period (a term of purchase).

How can you get into this game? Try calling Value Tec ([www.valutec.net/](http://www.valutec.net/)), one of the largest and most respected providers of gift cards. They help merchants issue gift cards. Your merchant service provider will already be set up to be able to accept and process payments from private issue gift cards, and most all terminals today are gift card ready. Purchases paid for via gift card simply become an itemized category on your monthly merchant service statement.

**Check Guarantee and/or Verification:** If you accept checks as payment you may want to consider obtaining a “check reader.” This is a machine that, similar to the credit card terminal, scans the check at the point of sale and instantly (similar to the credit card transaction) submits the data to the merchant service provider (processor) for acceptance or decline. If accepted, the processor assumes the collection risk. The processor also will deposit the funds in your account right away, similar to a credit or debit card sale. No deposits or bad check risk!

Check readers cost \$250 to \$500 and are most popular with retailers that process a high volume of checks and/or bear unusual risk in accepting checks. Riskier check acceptance environments include ones where checks are accepted for large amounts or where many out of town checks are submitted. □

## Merchant Credit Card Service Costs

**Discount Fee:** This is a percent of each credit card transaction paid to the processor for handling the transaction. A good discount fee today for a qualified Visa or M/C transaction\* is around 1.79 percent. Therefore, let’s say a customer purchases \$100 in services via credit card and your discount fee is 1.79 percent. Your processor will take \$1.79 off the top and you will net \$98.21 on the sale.

\* Discount fees vary based upon the risk characteristics of the particular transaction. There are many criteria that go into classification of a particular transaction, but transactions are generally classified as “qualified, mid-qualified and non-qualified.” To minimize fees, gain an understanding of your processor’s qualifying criteria and strive to qualify for low risk and thus low cost transactions.

**Transaction fee:** In addition to the discount fee, processors charge a flat fee per transaction. A competitive fee today is 25 cents. So, the above mentioned sample transaction will actually net you \$97.96 after the transaction fee.

**Statement Fee:** This is a monthly fee charged to you, the merchant, for providing you with a written statement. A competitive fee today is between \$5 and \$10 per statement.

**Monthly Minimum:** Most processor agreements have a minimum dollar volume that must be “run through the system” to avoid a monthly fee. For example, if you don’t charge at least \$1,700 in a month you will be charged, say, \$25.

**Equipment Charges:** The only equipment that might be needed is a terminal with a built-in printer to swipe cards and print receipts. These are simple little machines that cost around \$300 to \$600 new. Used and refurbished machines are also widely available. Not all merchants need a terminal, but to qualify for the lowest discount fees a terminal will probably be required. □

# The Performance Trap



**Andy Core, M.S.**

You want to perform at a higher level? Be more productive? Log better results?

Okay, how are you going to do that? Work harder? Work more?

Common answers, but you've just fallen

into the performance trap.

What's the performance trap? It's when you say "If I only had more \_\_\_\_\_, I'd be able to accomplish more."

I asked three different sales teams at three different Fortune 500 companies to fill in the blank. Ninety percent said "time." Not surprising given that spending more time at work has been the trend for fifty years.

The average work week has risen from 38.5 hours in 1950 to almost 50 hours today. Has performance increased? You bet. The problem is that our health has suffered.

Olympic athletes constantly search for higher performance. They've learned, however that the answer is not just to work longer and harder. That's the recipe for injury and burn out. So they looked elsewhere and discovered two areas that offer significant opportunity for increased performance:

1. State of physical health (heart rate, blood pressure, stress hormone level, etc.)
2. Daily Lifestyle (daily sleeping and eating patterns, leisure time, etc.)

Focusing on healthier lifestyle choices is the answer. It delivers substantial performance gains.

NASA studied and compared the performance of individuals that participated in a fitness program and persons who did not. Those that participated were 12.5% more productive at their jobs and exhibited higher levels of concentration and better decision making. Businesses today will spend a fortune to boost productivity just one percent. Fathom twelve percent!

So instead of working harder, work smarter. Take care of yourself and your body will take care of you. To start, adopt two new habits.

## Drink Water

Research shows that if you are 1% dehydrated you lose 10% of your mental and physical capacity. At 2% dehydrated you lose 25% production potential. Many people, probably you, regularly let themselves become dehydrated. This offers a significant opportunity for enhance performance. By simply drinking water (which is free) instead of coffee or soda, you potentially could experience a 25% boost in mental and physical energy.

## Get on Your Feet

By adding as little as fifteen minutes a day of additional physical activity you can decrease stress hormone production, increase the "feel good" brain chemicals, increase body temperature which promotes the same relaxed feeling you get from sitting in a hot tub, and increases alpha brain waves. If you have seen Yoga masters painlessly walk barefooted across red hot coals you have seen the power of alpha brain waves.

The fastest and most productive way to increase at-work activity is by MBWA – Management By Walking Around. Consider holding "walking meetings" versus "sit downs." This is as simple as saying "Bob, have a minute for a little MBWA?" With MBWA you can easily accumulate an additional 15 minutes of physical activity each day.

In conclusion, start today taking better care of yourself. Find meaningful performance gains by simply adopting some healthy habits. Drink more water and take more walks during the work day. It's free and will make you happier, more successful, and you'll live longer. Not a bad ROI. ☐

*Andy Core of Core Wellness contributed his expertise to this article. He can be reached at Andy@AndyCore.com.*

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**Contact us today at 800-634-0605!**

# Q&A

## Spousal Liability on Tax Returns

**Q:** The IRS has assessed fines and penalties against my former husband and me for taxes due on three tax returns filed while we were still married. I was not involved in the preparation of the returns. Should I be liable?

**A:** A husband and wife are generally jointly and individually responsible for the entire tax due on a joint return. However, relief from this rule is available under certain circumstances. The most substantial relief will be available to you if you can show evidence that:

- A. At the time of the signing of your tax return you did not know, or have reason to know, there was an understatement of tax, and
- B. Based on all the facts and circumstances it would be unfair to hold you liable as . . . you are innocent.

A key consideration for the IRS will be whether you benefited from the understatement of tax.

If you fail to meet the above criteria you could apply to have your personal tax liability separated from that of your former spouse. The burden will be on you, however, to prove the tax bill owed by you and your former spouse.

For more information, obtain publications 971 and 555 from [www.irs.gov](http://www.irs.gov). □

## Tax Audit Frequency is Rising

The IRS brought in a record \$43.1 billion in enforcement revenue in fiscal 2004. That's an increase of \$5.5 billion from the year before.

Audits of high-income taxpayers, those earning \$100,000 or more, topped \$195,000 in 2004. That's a 40 percent increase from 2003 and a 74 percent increase from 2002.

Total audits of all individual taxpayers topped 1 million for the first time since 1999. In 2004, we saw a nearly 19 percent increase from 2003 and almost a 36 percent jump from 2002.

After years of decline, audits of the largest businesses, those corporations with assets of \$10 million and over, climbed to 9,560. That's up from a low of 7,125 in 2003. One in six large corporations were audited in fiscal 2004.

The number of levies issued — a key enforcement tool — topped 2 million, a 21 percent increase from 2003 and triple the number in 2001.

Criminal investigation activity increased in several areas, including more than 3,000 recommended prosecutions, a nearly 20 percent jump.

Quotes from IRS Commissioner Mark W. Everson

*"We started to bring up the audits of large businesses this year. I expect to do the same for small businesses in 2005."*

*"Overall, these audit rates, while we've made progress, are still too low. We have more work to do. A vigorous enforcement program is important. The great majority of Americans pay their fair share of taxes. Americans deserve to feel confident that when they pay their taxes, neighbors and competitors are doing the same."*

Source: Internal Revenue Service □

## Choosing a Tax Return Preparer

- Avoid tax preparers who claim they can obtain larger refunds than other preparers.
- Avoid preparers who base their fee on a percentage of the amount of the refund.
- Use a reputable tax professional who signs your tax return and provides you with a copy for your records.
- Consider whether the individual or firm will be around to answer questions about the preparation of your tax return months, or even years after the return has been filed.
- Review your return before you sign it and ask questions on entries you don't understand.
- No matter who prepares your tax return, you (the taxpayer) are ultimately responsible for all of the information on your tax return. Therefore, never sign a blank tax form.
- Find out the preparer's credentials. Is he or she an accredited

**No matter who prepares your tax return, you (the taxpayer) are ultimately responsible for all of the information on your tax return.**

tax preparer, enrolled agent, certified public accountant (CPA), licensed public account or tax attorney? Only attorneys, CPAs and enrolled agents can represent taxpayers before the IRS in all matters including audits, collection and appeals. Other return preparers may only represent taxpayers for audits.

- Find out if the preparer is affiliated with a professional organization that provides its members with continuing education and resources and holds them to a code of ethics.
- Ask questions. Do you know anyone who has used the tax professional? Were they satisfied with the service they received?

Tax evasion is a risky crime, punishable by five years imprisonment and a \$250,000 fine. If you suspect tax fraud or know of an abusive return preparer, report it to your nearest IRS office. You can contact the IRS by phone at 1-800-829-0433.

Source: Internal Revenue Service, FS-2005-8, January 2005 □

**Capital Sources: Internal, Trade, Debt and Equity, continued from cover**

There are four primary sources of money: internal, trade, debt and equity.

**Internally Generated Funds**

Internal funds are those generated from or within the business itself. The most important internal source is profit, or more accurately, cash flow. The amount available, of course, is a function of how much is generated and retained in the business.

A non-recurring source of internally generated capital may be found by wringing out cash tied up in the balance sheet. This might include selling some machinery or equipment that is not necessary or is too expensive, or the unlocking of cash tied up in working capital. Here is Savvy Company's working capital:

<b>Savvy Company's Working Capital</b>	
Cash	\$100,000
Accounts Receivable	\$500,000
Inventory	\$300,000
<i>Total Current Assets</i>	<i>\$900,000</i>
Accounts Payable	\$200,000
Other Current Liabilities	\$200,000
<i>Total Current Liabilities</i>	<i>\$400,000</i>
<b>Working Capital</b>	<b>\$500,000</b>

As can be seen, Savvy has \$500,000 tied up in working capital (current assets minus current liabilities). However, if the business institutes practices that allow it to maintain less inventory and collect more rapidly on receivables, for example, cash can be generated (tax free).

For example, let's say that by devising and instituting some new policies, Savvy is able to support the current level of annual revenue with just \$450,000 in receivables (because they collect more quickly) and \$200,000 in inventory (because they become able to turn inventory more quickly), working capital can be reduced to \$350,000 ... \$150,000 in cash is generated.

Obviously, business managers should consider internal sources of cash, regardless of whether the cash is needed to fund business activities or could be distributed to the equity holders. Internal sources of capital are most desirable, reliable and lowest cost.

*Note: Internally generated cash actually becomes equity once it flows into the business, so be sure to read the equity section below.*

**Trade Credit**

Trade credit is what we call "terms" extended by suppliers. They send you goods but don't require you to pay for, say, 30 days. Trade credit is an absolutely essential and life-giving source of capital for most businesses. It is a substantial portion of the capital structure of most businesses and, best of all, is interest free.

Because of the low cost, most businesses attempt to maximize the trade credit they can obtain. Seasoned business owners preach caution in stretching trade credit balances, as trade credit may be most valuable during times of trouble. If your trade creditors are

pushed to the limit all the time, there will be no room for more when the inevitable "pinch" hits.

Trade credit is unsecured debt, meaning the suppliers don't require you to pledge any assets against the "loan." This means that if the business fails and there is no money left over after the secured creditors are paid, the trade creditors will go unpaid. So, when you hear someone say "suppliers cut them off" or "put them on COD," it's because trade creditors need to be cautious.

**Debt Capital**

Debt is simply the borrowing of money with a promise to repay ... with interest. Banks are the primary debt lenders in our society, but credit unions, investment banks and insurance companies also lend money. The amount borrowed and terms of repayment are usually documented in writing via a promissory note or "note," signed by both lender and borrower.

The term may be for days or years, and it is imperative that the term and terms match the use. For a short-term need, such as the financing of a large receivable that should be collected soon, the note term should match. For assets with a long productive life such as real estate, long-term loans are appropriate.

Some notes call for regular payments of principal and interest, such as a loan to buy equipment. Others are interest only. It is not chance that dictates whether principal is due in installments or all at once at maturity. Regular principal payments are appropriate when the borrowing is for an asset that has a steady productive life and should regularly generate profits (or contributing to such). If the purpose is reasonable working capital, it makes sense to repay principal in full at the end of the season, for example.

Interest-bearing debt financing is sought when trade debt sources are extinguished. Interest-bearing debt is more expensive than trade debt but it's cheaper than equity. It is also generally considered more risky than equity for two reasons:

- a. Debt capital requires repayment according to specific terms. The expense and repayment both consume cash on an ongoing business. And, if you fail to meet the terms, you could be sued or assets could be seized for repayment.
- b. Lenders (those that provide interest-bearing debt capital) enjoy a priority claim on the assets of the business. That means that if the business becomes unable to pay its bills, the assets of the business will first go to repay the debt lenders. More particularly, the secured creditors (lenders of debt) are paid first, then the unsecured creditors such as trade creditors. Then, if there is money left over, it will go to the owners (equity holders).

In a secured loan, the borrower pledges certain assets as collateral (security) to protect the lender in case of default on the loan. If the

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**Fail to appropriately match financing need with source and you risk losing money, time, credibility or worse – your business.**

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*continued on next page*

business defaults on the loan, the note holder (lender) assumes ownership of the collateral. In long-term borrowing, fixed assets such as real estate or equipment are usually pledged as collateral. For short-term borrowing, inventories or accounts receivable are the norm. Credit cards are a form of unsecured debt capital.

**Equity Capital**

Equity capital is the longest term financing available to a business. In fact, it's considered permanent (no repayment term). Yes, equity capital comes with no payment obligation and monies only flow to the equity holders when all other obligations have been met. This means that equity capital is the most risky. If the business does not succeed and must be liquidated, the equity holders only get what is left over (if any).

Equity capital is the most expensive form of capital. This makes sense when you consider the risk. For example, a loan (debt financing) today might charge an annual rate of seven or eight percent. Try to sell an equity stake in your business and investors might demand well north of 30%. Now, if the terms of the equity sale require a return, it's not really a pure equity position. When we say, "demand well north of 30%," we mean the investor must believe he will earn it (their "hurdle rate") ... or he won't invest.

Equity capital is illiquid (hard to sell). Unlike trade credit or a bank loan, which can be replaced easily with another supplier or lender, equity is not easy to sell or exchange. This is another reason for the higher rate of return – compensation for the risk inherent in the illiquidity.

Many businesses don't earn a return for their investor(s). This is common in small businesses where the equity holder (owner) is also the full time manager. The owner will pay himself or herself a salary (wage for his or her contribution of time and talent) and there will be little or no profit left over. If equity distributions are made, it's allocated on a pro-rata basis (i.e. according to ownership percent), unless there is more than one class of stock (rare in a small business).

Equity is the foundation of a business' capital structure. The way a business is financed is referred to as its capital structure. Another way to understand "capital structure" is to identify the source of the money. The most important piece is the equity. If the equity contribution is sufficient, other types of capital providers might be willing to contribute capital (money) to your business. For example, if you need \$500,000 in equipment, a lender will typically not lend you \$500,000. After all, tangible assets decline in value over time and, given that lenders charge fairly low rates of interest, they can't afford a lot of risk (lost principle). Lenders need a cushion. They want you to contribute, say, 20 percent of the purchase price with equity. Then they will lend the other 80 percent. If you default on the loan, they will get the entire piece of equipment and your equity will be lost. Just as the equity serves as a cushion for the lender on the equipment loan, the overall level of equity in the business serves as a cushion for all non-equity contributors of capital.

Does all this sound unfair? Before you, the equity holder, get too uncomfortable, consider that the trade creditor earns no interest. The debt capital provider just gets a few percentage points in interest and some fees. You, the equity holder, can earn as high a return as you are able to muster. There is no limit to your upside.

Equity is also unique in that the holders of equity dictate how the business is managed. They, in effect, are the people who determine the other capital sources. Therefore, equity is the most risky capital, but the holders of it have the most influence in how the business is managed.

Finally, growing companies consume cash. It's just the way it works. Sales and profit growth follow expenditures such as: the hiring of additional employees; the purchase of more inventory, materials and equipment; the leasing of a larger facility, etc. And, as we discussed above, creditors (debt and trade credit) don't want to finance 100 percent. So, growing businesses need a continuous supply of equity capital – internal generated cash or equity obtained from investors.

**Summary**

Money is the lifeblood of a business. Business owners must understand sources and uses of money (capital) to be effective. By effective, we mean appropriately match the need with the type so that the business remains well capitalized (has enough money), does not run into financial crisis (liquidity crunches that inordinately distract management, damage credibility and increase risk), and minimize cost of capital and therefore maximize the return to the equity holders. □

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*"I can't sleep. I just got this incredible craving for capital."*

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**BUSINESS VALUATION**

**Business Valuation Basics: Four Key Questions, continued from page 6**

definition is straightforward. The essence of the meaning can be readily understood by simply taking a few moments to ponder the definition.

Value as of What Date? The fourth basic question to be answered before a business can be valued is "value as of what date?" Of course, one could always assume the answer is today. However, this is not always the case. In litigation, we often want to know what the value was on a particular date in the past. For instance the date of damage, breach, loss or death. Conversely, in finance we often need to predict what the value will be at some date in the future, such as when we expect a business or asset to be sold. □

# Eight Steps to Building a Successful Transition Plan

Transitioning a family business is a delicate, time consuming and potentially hazardous undertaking. There are numerous tax and non-tax factors to consider. Common complexities include how to handle family members that work in the business vs. those that do not, and liquidity issues that inevitably arise when the bulk of the family's wealth is tied up in the productive assets of business.

When embarking on this journey, consider the following suggestions:

1. Give deference to the unique talents, interests and needs of each family member. Rather than arbitrarily dividing the wealth equally, rationally assess the particular needs of each family member. Look at each individual's goals, objectives and ability to handle wealth.
2. Empathize with those who contribute to the success of the business. Put yourself in the shoes of family members who have helped build the business with their talent, sweat and tears. Is it fair to divide the business equally among the participating and non-participating family members alike?
3. Time to diversify? There is a great deal of truth to the adage "Avoid putting all of your eggs in one basket." Is there wealth outside of the business that can be transferred to non-participating family members? If not, it might be just another message that it is time to diversify.
4. Buy-out non-active family members. If dividing your business among all family members is your ultimate decision, consider a plan that includes a means by which the active members may buy-out the non-participating family members.
5. Don't let taxes wag the dog. Taxes are important. However, they should not be the driving force in developing your succession plan. First, identify your goals and objectives for

the business and your family. Then, investigate strategies for tax minimization.

6. Get expert advice. This typically means accessing one or more of the following professionals: attorney, accountant, trust officer, financial planner and business appraiser. The bottom line is that the final product requires the expertise of professionals who do this type of work for a living.
7. Communicate the plan. As soon as reasonably possible, meet with the family to communicate the plan. The purpose of the meeting is not necessarily to gain approval, but to outline your goals, explain how the plan meets the goals and answer questions. It's best to get everything on the table as early as possible rather than wait for someone to be surprised.
8. Revisit the plan. Never put a plan to rest. To meet ongoing changes the plan must be regularly reviewed and updated. □

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**"What do you want to do? What do you want to be? What do you want to have? Where do you want to go? Who do you want to go with? How the hell do you plan to get there? Write it down. Go do it. Enjoy it. It doesn't get much simpler or better than that."**

*Lee Iacocca*

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