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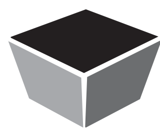

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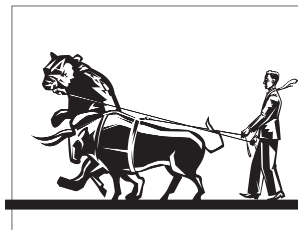
Manage Effectively in a Recession



Anyone can manage during good times. But when the economy turns downward, businesses can fail because of poor management.

As a manager, what should you do differently during a recession? Here are a few of the basics:

Focus on receivables: In difficult times, business bankruptcies rise. In every case, creditors go unpaid. Typically, unsecured (trade) creditors get stiffed. But some manage to get paid, so make sure you're one of them. Do this by developing a strong relationship with the accounts-payable person on troubled accounts. Also, set limits. Establish requirements. And be sure you don't extend more credit to any single customer than you are financially comfortable with. Finally, being firm and managing your exposure does not mean treating anyone disrespectfully. Don't make it personal. You don't want to lose a customer forever just because of tough times.

Postpone unnecessary expenditures: If you are considering spending money on "nice to haves," consider postponing. Especially expenditures that raise your cost base for years to come and are difficult or expensive to reverse. An example would be buying or leasing a larger or nicer facility. You might want to wait until you get a feel for how things will go during the recession before you make a big move that raises your cost base.

Squeeze cash from inventory: Inventory ties up a lot of cash. Good managers need to be good inventory managers, taking care not to over-order or end up with too much that can't be sold. Now might be the time to start reducing inventory stocks and raising cash, especially on slower-moving items.

Sharpen the saw: When sales slow down, you're not as busy, so it's a good time to sharpen the saw. Work on the database. Meet and discuss unresolved issues. Investigate strategic alliances, new initiatives, and new locations. Get out and talk with your customers. It's just like winter: not a time

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- What You Need to Know About Appraisals
- Incremental Cost Analysis: A Quick Way to Save Money on Quantity Purchases
- Oldest Family Business in the United States

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From the Editor

David L. Perkins, Jr.

Stand back and look at this crazy world. Who knew that banks had billions of dollars in uncollectible residential mortgages on their balance sheets? Or that they all would come clean about it at the same time?

Then a 30-year-old French trader tried to "show the boss" that he could make money trading — and lost $7.2 billion. These corporations throw billions around like nickels.

Stock markets around the world tumbled and then the Federal Reserve, which is supposed to be the perennial force of calm and rationality, dropped interest rates just as reactively as the rest of the knee-jerk world.

One thing's for sure, business ownership is not for the faint of heart. Ditto for investing. This issue of *The Business Owner Journal* starts with suggestions for managing your business during a recession (cover article). But you'll also find articles about trade credit and receivables collection policies. If we are headed for a recession, it's time to pay close attention to our trade credit. A lost receivable can quickly erase a lot of hard-earned profit and put a serious hurt on cash flow. Don't let it happen to you.

Sincerely,

David L. Perkins, Jr.
Publisher and Editor

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Protect Yourself Before Sending a Deposit or Down Payment

Sometimes you, as a buyer, are required to turn over large sums of cash as a down payment or deposit on a purchase. Typically, this occurs with expensive assets such as a piece of machinery, a boat or a construction project. It's not much of a concern when you have been dealing with the same supplier for years, or you know that the vendor is well known and well capitalized. But it can be a source of stress and even serious risk when you deal with a person or firm that you have little experience with and/or that is not well known. Depending on the type of purchase, there are several ways to protect yourself.

If the deposit is a down payment on a future construction project, you might insist that part or all of the deposit be placed in an escrow account that requires authorization by both your and the contractor's lawyer to release funds.

If the amount is substantial and the project will take a long time to complete, e.g., six months or longer, obtain a performance bond from the contractor. For reputable contractors, this is a normal procedure. They can obtain a performance bond from their insurance brokers. But if the contractor can't produce a bond — beware! Protect yourself by making payments only as progress is made on your project (i.e., progress payments).

If your supplier's supplier requires a deposit (e.g., as part of a machinery order), insist on seeing the receipt from your supplier's order, or better yet, make the payment yourself. This assures you that your supplier isn't using your money to fund other purchases.

For large-dollar purchases, have your attorney review the order form or purchase agreement before signing it, even if the supplier says he's using a standard order form. Be sure the document clearly lays out all important terms, such as when the product (or service) is to be delivered, terms of payment, and what specific work is to be completed.

If "time is of the essence" on the delivery, this should be indicated in the contract along with a specific must-have delivery date and penalties or cancellation rights for late delivery.

If your purchases are stored in facilities not owned or leased by you, such as at your supplier's place of business, be sure that all parties can easily identify, at all times, which assets are yours and which are owned by other parties. Check with your lawyer about perfecting legal title (by a UCC filing). For example, make sure that if the supplier becomes insolvent, creditors of the supplier don't seize your property under the assumption that it actually belongs to your supplier.

In all cases, use your good judgment. If the deal sounds too good to be true, it probably is. Do the terms pass the smell test? Is the firm well established? Do you know other persons or firms that have used this vendor? Have you checked references? Is the vendor's representative unusually pushy or in a hurry? Are there "missing links"?

If your instincts say "something's fishy," pull back. You always have alternatives. Resist the thought that you have to take the risk because of time pressure or because there are no other vendors. There are always alternatives.

If your good judgment tells you that there is unreasonable risk in sending the deposit, find a firm that gives you a higher level of comfort. ❑

New Rules for Tax Preparers Could Impact You

If you find your tax preparer being a little more difficult than usual, the reason may be the Small Business and Work Opportunity Act of 2007, enacted last year. This law changed the rules of the game played between you, the IRS and your tax preparer.

To be sure, the tax system is a game. It's not that dollars aren't real and funding government programs such as national defense and Social Security isn't important, but the nature of system itself is a game:

2007 law changes the rules of the game played between you, the IRS and your tax preparer.

Assess Current Position. Calculate how much income of various types you earned during the period (and options for taking income and expense during the period).

Assess Wager Options. Evaluate various rules, methodologies and strategies for minimizing tax and the relative risk of each maneuver.

Place Bets. Submit tax calculation and payment to the IRS.

Await Outcome. Wait to see if the IRS audits and/or assesses additional taxes and/or penalties (financial and other).

How the game has changed: The Small Business and Work Opportunity Act of 2007 changed the game, increasing the liability borne by tax preparers, by:

- Making it easier for the IRS to claim that tax preparers were accomplices in helping unjustly lower clients' taxes.
- Raising the financial penalty for taxpayers found to have assisted tax preparers in avoiding taxes.

The new law expands preparer penalties.

Why the IRS changed the game: As you are aware, the United States is running a stunning budget deficit. It spends about $1.4 billion per day more than it brings in. As a result, the current total U.S. debt stands around $9.2 trillion, or $30,000 per day for every man, woman and child in the country. This is not good. To remedy the situation, the government has only a few choices: reduce spending, increase income or both.

Well, our elected representatives are not very good at reducing spending. This is evident. On the income side, raising taxes is not politically popular. One option is the tax gap, the difference between taxes due (i.e., those that should be paid under current tax laws if everyone "played by the rules") and those that are actually paid. The last time the IRS went to great lengths to estimate the tax gap was 2001. Then the gap was estimated at $300 billion, i.e., about 85 cents of every dollar due under the law ($2 trillion due vs. $1.7 billion collected).

Closing the tax gap: The tax gap exists because of the complexity of the U.S. tax code (which gives rise to honest errors) and lax IRS enforcement (more people cheat when the likelihood of getting caught is low). Unfortunately, ready solutions are difficult to put in place. First, simplification of the tax code requires Congress to agree on a new code and to potentially put a lot of people out of work (tax advisors and preparers). That's a tough one. Second, greater IRS enforcement, such as more audits, requires raising IRS expenses (and the size of the federal budget). These two are also very unpopular with voters. So a third option is to enlist the help — or reduce the impact — of enablers, i.e., tax preparers (gatekeepers).

Tax preparers are privy to, and often craft, tax strategies used by taxpayers. So one way for the IRS to potentially lower the number of "cheats" is to deputize tax preparers. In effect, the new law moves us a little more in that direction. Yes, the tax preparers have borne some risk in assisting tax cheats, but the new law lowers the threshold for determining that a preparer is an accomplice and also increases the financial penalty that can be levied on the preparer.

Deputizing tax preparers: The new law expands preparer penalties beyond income tax returns to all types of returns: employment, excise, exempt organization, estate and gift tax. It also raises penalties ("first tier" penalties increase from $250 per return to the greater of $1,000 or 50% of the income from preparing the return, and "second tier" penalties for willful or reckless conduct in preparing a return increase from $1,000 per return to the greater of $5,000 or 50% of the income from preparing the return) and expands the standard of conduct subject to penalty.

The new law also emphasizes the importance to preparers of understanding the legal basis for positions taken on tax returns, the requirement for taxpayers to disclose certain positions, and the need for preparers to advise taxpayers on various penalties that can apply when a position is taken on a return that may not be supported by existing law.

So although "deputizing" may be a bit of a stretch, the new law may cause your preparer to think a little more about the risk he or she may bear in helping you take an aggressive tax stance to reduce your tax bill. ❑

Sources:

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Fraud Prevention: Lessons Learned from Société Générale's $7.2 Billion Loss

Fraud is prevalent in our society. It hits people rich and poor and businesses large and small. It will hit you and your business if you are not vigilant in your efforts to prevent it.

The recent $7.2 billion loss reportedly suffered by Société Générale at the hands of rogue trader Jerome Kerviel apparently could have been prevented had Société Générale adhered to a very basic fraud prevention strategy: Require all employees to take an extended vacation — a week or more — at least once a year.

Yes, our world is highly evolved and complex, but even so, effectiveness, profitability and risk minimization often come down to simple things that legendary college football coach Lou Holtz calls blocking and tackling.

The Wall Street Journal reported on January 29, 2008 that Kerviel had not taken a vacation in years. It said that his supervisors "tried on several occasions to make (him) take a few weeks off but ultimately went along with his excuses for staying at work."

Fraud in Small Businesses

Scheme	Percentage
Check Tampering	29.1%
Skimming	27.6%
Billing	24.7%
Expense Reimbursements	23.1%
Corruption	22.8%
Cash Larceny	19.7%
Payroll	17.8%
Non-Cash	17.6%
Financial Statement Fraud	12.1%
Wire Transfers	7.6%
Register Disbursements	1.6%

Fraud Facts

Here are recent findings of the Association of Certified Fraud Examiners (ACFE) from its Report to the Nation on Occupational Fraud & Abuse:

- Occupational fraud schemes can be very difficult to detect. The median length of the schemes in the study was 18 months from the time the fraud began until the time it was detected.
- Certain anti-fraud controls can have a measurable impact on an organization's exposure to fraud. Organizations that had anonymous fraud hotlines suffered a median loss of $100,000, whereas organizations without hotlines had a median loss of $200,000. Similar reductions in fraud losses were found for organizations that had internal audit departments, that regularly performed surprise audits, and that conducted anti-fraud training for their employees and managers.
- U.S. organizations lose 5% of their annual revenues to fraud. Applied to the estimated 2006 United States Gross Domestic Product, this 5% figure would translate to approximately $652 billion in fraud losses.
- Small businesses continue to suffer disproportionate fraud losses. The median loss suffered by organizations with fewer than 100 employees was $190,000 per scheme. This was higher than even the largest organizations.
- One reason that small businesses suffer such high fraud losses is that they generally do a poor job of proactively detecting fraud.
- Most occupational fraud schemes involve the accounting department or upper management. Just over 30% of the cases were committed by employees in the accounting department, and slightly more than 20% were committed by upper management or executive-level employees. The next most commonly cited department was sales, which accounted for 14% of the cases in our study.

What You Must Do

To lower your risk of suffering financial loss due to fraud perpetrated by your own employees:

- Install an anonymous fraud reporting hotline. Try offerings by EthicsPoint (www.EthicsPoint.com) or Silent Whistle from Allegiance (866-794-4785).
- Separate the money from the recordkeeping.

  Don't let the same person who receives and records receipts also book sales, generate invoices and reconcile receivables.

  Don't let the same person who approves purchases also pay for them (and the person who pays for purchases should be able to make a payment only when it is accompanied by appropriate approval documentation).

  For assistance in implementing these checks and balances, contact your tax preparer or certified public accountant.
- Require all of your employees to attend an annual anti-fraud training program. For options in your community, call your lawyer, staffing firm or human resource consultant. They'll be able to point you in the right direction.
- Require all accounting, financial and purchasing personnel to take 1.5 weeks off every year. Equally as important is not to let vacationing employees' work stack up. Have another employee do all of the daily and weekly tasks of the vacationing one. This will require some cross-training but is essential.
- The business owner should directly receive and review unopened credit card statements and bank statements. Alternatively, have them sent to your accountant before they go to the bookkeeper.
- Personally sign all outgoing checks and require expenditure-approving paperwork to be attached to each check submitted for your signature.

The apparent fraud at Société Générale will in all likelihood put this venerable world bank out of business. The shame is that it easily could have been prevented if the bank had followed the simple guidelines offered above. And to be sure, fraud happens all the time in all sizes of businesses. Don't let it happen in yours. ❑

Common Types of Fraud Perpetrated on Small Businesses

Type of Fraud	Percentage of Cases	Description	Example	Solution(s)
Check Tampering	29.1%	Any scheme in which a person steals his/her employer's funds by forging or altering a check on one of the organization's bank accounts, or steals a check the organization has legitimately issued to another payee.	Employee steals blank company checks, makes them out to himself/herself or an accomplice.	• Keep blank checks locked up. • Account for all checks, including voids. • Insist on timely bank receipts, and review them.
Skimming	27.6%	Any scheme in which cash is stolen from an organization before it is recorded on the organization's books and records.	Employee accepts payment from a customer but does not record the sale.	Ensure that receipts are issued for every sale, and balance cash to total receipts at end of day.
Billing	24.7%	Any scheme in which a person causes his/her employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices or invoices for personal purchases.	Employee creates a shell company and bills employer for nonexistent services. Employee purchases personal items, submits invoice for payment.	• Require signed approval for all expenditures. • Separate duties of approving invoices and cutting of the checks/issuing payment. • Periodically review vendor listing.
Expense Reimbursement	23.1%	Any scheme in which an employee makes a claim for reimbursement of fictitious or inflated business expenses.	Employee files fraudulent expense report, claiming personal travel, nonexistent meals, etc.	• Require receipts, with business reason stated, for all reimbursed items (over a given amount, e.g., $25). • Require approval signature on all reimbursements. • Track expense reimbursement claims against historicals and across peers to look for trends.
Cash Larceny	19.7%	Any scheme in which cash is stolen from an organization after it has been recorded on the organization's books and records.	Employee steals cash and checks from daily receipts before they can be deposited in the bank. (These may or may not have been recorded on the organization's books at this point.) Employee steals outgoing check to a vendor, deposits it into his or her own bank account. (Not nearly as likely as the shell company scheme, because the vendor will call to inquire.)	Business owner opens all mail and stamps all checks on the back "for deposit only with your company." Investigate all bad debts.
Payroll	17.8%	Any scheme in which an employee causes his/her employer to issue a payment by making false claims for compensation.	Employee claims overtime for unworked hours. Employee adds ghost employees to the payroll.	• Require that all time cards be signed. • Periodically require all employees to pick up their checks in person; investigate any checks not picked up.
Non-Cash	17.6%	Any scheme involving theft or misappropriation of non-cash assets such as inventory, information or securities.	Employee steals merchandise from warehouse or sales floor. Employee diverts incoming inventory for personal use.	Enlist tight inventory controls, including periodic counts as considered necessary and practical; surveillance cameras and strong physical security; make the inventory manager accountable for pilferage.

Common Types of Fraud Perpetrated on Small Businesses, **continued from previous page**

Type of Fraud	Percentage of Cases	Description	Example	Solution(s)
Corruption	22.8%			
• Conflict of Interest		Conflict of Interest: An employee, manager or executive has an undisclosed economic or personal interest in a transaction that adversely affects the company results.	Conflict of Interest: An employee owns an undisclosed interest in a supplier. The employee negotiates a contract between his employer and the supplier, purchasing materials at an inflated price.	Conflict of Interest: • Implement policy requiring signed disclosure of any such interest. • Personally investigate and approve all suppliers. • Allow checks to be cut only for approved vendors. • Require periodic competing bids, and get a bid or two yourself.
• Bribery		Bribery: A person offers, gives, receives or solicits something of value for the purpose of influencing an official act or a business decision without the knowledge or consent of the principal.	Bribery: An employee processes inflated invoices from a vendor and in return receives 10% of the invoice price as a kickback. An employee accepts payment from a vendor in return for providing confidential information about a competitor's bid on a project.	Bribery: Same as Conflict of Interest, above. In addition, periodically review payments to see that amounts are reasonable.
• Illegal Gratuities		Illegal Gratuities: A person offers, gives, receives or solicits something of value for, or because of, an official act or business decision without the knowledge or consent of the principal.	Illegal Gratuities: An official negotiates an agreement with a contractor, and in appreciation the contractor provides the official with a gift such as a free vacation.	See NOTE at bottom.
• Extortion		Extortion: The coercion of another to enter into a transaction or deliver a property based on wrongful use of actual or threatened force, fear or economic duress.	Extortion: An employee refuses to purchase goods or services from a vendor unless the vendor hires one of the employee's relatives.	See NOTE at bottom.
Other	21.7%	Financial statement fraud (12.1%), wire transfers (7.6%) and register disbursements (1.6%).		

NOTE: It is extremely difficult, if not impossible, to prevent fraud in which collusion is involved. Also, some of the above scenarios (extortion, bribery, kickbacks, etc.) are less tangible than others and therefore more difficult to detect. It is important to look for unusual changes in an employee's lifestyle or standard of living. For example, is he/she driving a more expensive car than he/she can afford or than he/she has in the past? Has he/she started buying more expensive clothes or exhibited "affluence" that appears to be beyond what would be expected based on his/her pay? Has he/she been on what seems like an unusually exotic/expensive vacation? Has he/she recently moved his/her children from public to private schools? While certainly not an all-inclusive list, these are all things to watch for if an employee is suspected of wrongdoing.

It is important to look for unusual changes in an employee's lifestyle or standard of living.

General practices that can help prevent or detect fraud in the workplace are quality background checks (not the $10 online kind), as well as establishment of a fraud hotline that gives employees a telephone number to call anonymously if they suspect a co-worker. Finally, every employee who works with cash and/or financial records should be required to take at least a one-week vacation each year; countless schemes have been uncovered when the guilty employee was away and unable to continue covering up his/her crimes. ❑

Interest Rates Declining Again: Time to Refinance?

In our May/June 2004 issue, page 10, in an article titled "Gentlemen: Start Locking In Your Interest Rates," we predicted rates would soon begin climbing. To that end, we urged you to lock in your rates (prime rate stood at 4%) to protect yourself. Well, our advice proved to be timely. In July of that year, the Fed began raising the federal funds rate (referred to as tightening the credit markets). The prime rate also began its rise, and by the summer of 2006 it was 8.25% — more than double the rate of two years earlier.

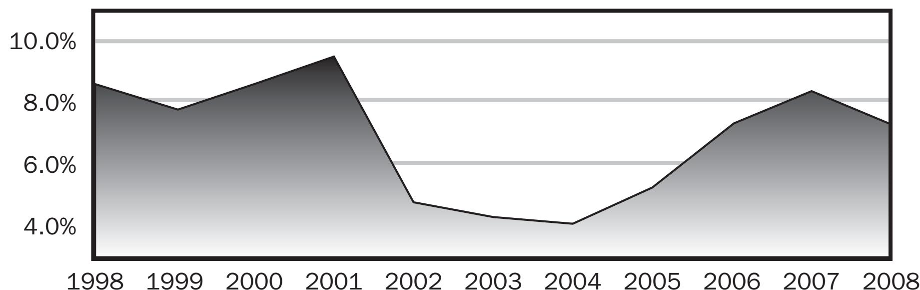
Amazingly, rates are on their way back down again. The prime rate is 6% — which is 2.25% lower than it was just last fall.

What does this have to do with you? I suggest that — if you have outstanding debt at rates of 7% or above — you consider refinancing with fixed-rate debt at the low current rate.

Could rates go down even more? Absolutely. These things are hard to predict, but given historical rates of the past 50 years, 6% is pretty darn low.

Do I think we run a risk of rates rising rapidly — as in the summer of 2004? No. Not at this time. But these things are cyclical, and now's the time to begin thinking about locking in debt at lower rates. You know, I didn't think we'd get back here this soon, but thanks to the mortgage crisis, here we are again. ❑

Historical U.S. Prime Rate of Interest



MANAGEMENT

***Manage Effectively in a Recession,* continued from cover**

of death, simply a time to shed excess and re-create yourself. Clean up and get in shape and re-emerge as a better, faster, stronger and more beautiful you.

Reduce interest expense: As a broader expansionary cycle grows long in the tooth and recession signs begin to flash, good managers begin paying down debt. Consider using proceeds from selling off excess assets, such as inventory and receivables. But to the extent interest-bearing debt remains, a recession is often the time to refinance. That's because interest rates typically decline during an economic slowdown. If necessary, you also can extend the amortization period (to lower the amount of principal payments).

The staff of *The Business Owner* has been predicting an economic slowdown for a year now. It's here. Could it become a recession, i.e., negative gross domestic product (GDP) growth? Sure could.

How long will it last? Well, whether it's a slowdown (lower GDP growth) or a recession, they usually last just a year or two, and we see no reason why this one would be any different. The U.S. economy is incredibly powerful, dynamic and industrious. We believe that the global economy is poised for many years of healthy growth as the benefits of technology, rising literacy rates and lowering barriers to trade drive demand and world GDP. So don't put your head in the sand. Yes, business could get pretty slow for you this year, and possibly next. But good managers know how to take advantage of it. ❑

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David L. Perkins, Jr. owns, writes and publishes *The Business Owner*, the newsletter of choice for more than 35,000 business owners who are serious about building wealth through successful private business ownership.

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

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

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

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Getting Paid: Sound Credit Policy and Collection Procedures

Nearly every company offers credit to its customers. If you provide goods or services before receiving payment in full, then you are extending credit. For many companies, this is an essential part of the business. Losses are unavoidable but must be minimized. All business owners should know the normal level of bad debt loss for companies of their type. If you don't, get the data from your trade association. If, after doing some research and comparison, you are unhappy with your loss rate, consider revising your credit policy and collection procedures.

To begin, gather ideas and examples from your accountant and peers. Consult your attorney about collection laws, and check with your trade association for policies and procedures tailored to your type of business. Consider the following:

Qualify the customer: Identify types of sales or services causing unacceptable collection losses or that could do so in the future. Consider how this risk could be minimized. A good place to start is by checking credit ratings of new customers who request credit from you. Checking a company's credit rating is inexpensive and easy. See "Check 'Ability to Pay' Before Approving Credit Sale" on page 10.

Credit policy and collection procedures can make or break a company.

Set credit limits: Regardless of the apparent credit strength of any new customer, set credit limits that keep the risk you bear to a manageable level. Review limits periodically in light of payment performance. Keep in mind that even the seemingly strongest companies in the world can suddenly go bankrupt (e.g., Enron, Penn Central, Kmart, Polaroid). Don't bet your company on the future solvency of any single customer, or that a receivable won't come under dispute.

Don't give customers reasons to delay or dispute: Make sure each sale is recorded accurately and is supported by a purchase order signed by the customer. All purchase orders should obligate the customer to your terms of sale and payment. Be sure that the order is processed without errors and shipped on time, and that the invoice is correct and delivered in a timely manner. Don't give a customer any reason to dispute the order or bill, and control the terms of payment.

Work out any problems: If an item is disputed, address it immediately. Find out the exact nature of the problem, and then take steps to remedy it. If the customer promises to pay, insist on specifics. What day will it be paid? Offer to pick up the payment on that date. If the customer offers to pay a partial amount today, accept it. If a customer is in financial difficulty and the amount due is sizable, try to get a formal note executed for the full amount due with a specific repayment schedule and interest rate.

Remind, remind, remind: Your collection procedures should include built-in reminders and action steps. For example, a written reminder should be sent as the due date approaches. If payment is not received within a few days, send an email or make a call. If the due date passes, call the customer promptly.

Steadily raise the level of firmness: While being sensitive to particular circumstances, the level of firmness should be steadily increased as the receivable becomes more dated. Begin by sending the customer a letter, on company letterhead and with your attorney visibly copied, requesting immediate payment. If the desired response is not obtained, have your attorney send a letter on his or her letterhead explaining what will occur if the bill is not paid. Be sure you follow through as asserted.

Time really is money: The longer you wait on past-due accounts receivable, the less likely you are to be paid. Statistics show that once a receivable is 120 days past due, 20% will be lost. When a receivable falls to 180 days overdue, the loss increases to 33%. The chance of collecting a year-old bill is about 50-50, and only 25% of receivables over two years old will be collected. Collect as fast as you can. Start by building into your system ways to get your cash up-front or very quickly. Offer to take payment at the time of order. You might be surprised by how many will do so. Consider offering a 1% or 2% discount on all invoices paid quickly, such as within

continued on page 11

Maximize Receivables Collection Without Alienating Customers

When it comes to collecting trade receivables, effectiveness is as much **savvy** as **system**. The #1 rule is persistence. In collections, the squeaky wheel really does get the grease. At the very least, be sure your company is top-of-mind with the payables clerk. Your collection staff should maintain a friendly relationship with him or her and, ideally, it should be strong enough to obtain a favor when needed.

When making a call to collect a past-due account, allow the customer to maintain his or her integrity. Don't blame the person; blame the situation.

It makes sense for the people in your organization that do the collections to be different from the people doing the selling. Shield yourself and your sales staff from potential relationship strain that could arise out of the credit and collection process. Try to have an accounting person handle collections.

When problems occur with collection, avoid blaming individuals. The problem should always be with policy. The attitude should be that your company's policy is an immovable force and is reasonable. As deadlines are pushed, the clerk of your delinquent customer should feel the hurt of his/her counterpart responsible for collecting.

Considerable pressure can be exerted on the delinquent customer when credit policy prevents new orders from shipping until payments are received. Every credit policy should limit both the total amount of credit extended and the time allowed for payment of any invoice (days from invoice date). If either is reached, orders must stop. Although your sales force may raise hell, you must prove that the rules cannot be bent. Soon your sales force will leave you alone and look for other solutions (e.g., customer payment). Your salesperson always should identify with customers' purchasing agents in cursing the rules but also subtly convince customers that the policies are normal and fair.

When making a call to collect a past-due account, allow the customer to maintain his or her integrity. Don't blame the person; blame the situation. Assume the customer is immensely busy and apologize for any intrusion. Listen to his/her problems with empathy, whether of a personal or business nature. Then be firm that the matter must be cleared up somehow. Get them to brainstorm for solutions. Offer ideas and help anyway you can: reminders, resend invoice copies, pick up the check personally, etc. If they repeatedly resist, remind them that they must comply with the rules they agreed to when they purchased your goods or services. Of course, be sure your standard sales procedures include the customer's written consent to your rules for granting credit.

Finally, don't be concerned with whether all creditors are paid, only whether YOU are paid. Make sure you are paid first, or at least early, and before things deteriorate. **Note:** Advice in this article should be considered in tandem with that in "Getting Paid: Sound Credit Policy and Collection Procedures," on page 9. ❑

Check "Ability to Pay" Before Approving Credit Sale

To get credit information on small businesses in the United States, distribution channels may have changed since our report in the November 1979 issue of *The Business Owner*, but Dunn & Bradstreet ("D&B") is still the undisputed leader.

Today D&B have increased their credit reporting to more than 100 million U. S. companies, most of which have fewer than 10 employees. Simply go to www.smallbusiness.dnb.com or call Dun & Bradstreet toll-free at 1-800-234-3867. Its basic Credit eValuator Report is $39.99, or $25.49 per report with a monthly subscription to Credit Basics of $22 per month.

But don't rely entirely on the data in a credit report. D&B allows self-reporting of data, so information can be incomplete and, at times, inaccurate.

Checking an individual's ability to pay

There are three major reporting credit repositories: Equifax (www.equifax.com), Experian (www.experian.com) and Trans Union (www.transunion.com). All three offer easy access on the Internet or using desktop software. The enrollment process is similar for each. You'll be asked to fill out an application and pay a small fee. You'll enjoy access to a nationwide credit-reporting database containing "Revolving," "Open" and "Installment" credit items, paid and unpaid amounts, public records, tax liens, bankruptcies and judgments. Reports can be delivered almost immediately on request, and right now Experian is offering a free 30-day trial of its Triple Advantage program, which normally costs $14.95 per month.

The federal government also offers one free credit file disclosure each year to check your own credit from the three bureaus listed above. Go to www.annualcreditreport.com to find your credit score.

To learn more about the information provided on a credit report, or about "scoring" products that can help determine a creditor's ability to pay, visit the websites listed above or try calling Experian's Credit Services at 1-888-243-6951. ❑

Accelerate Cash Flow: Offer an Early-Pay Discount?

When it comes to collecting trade receivables, time **really** is money. Statistics show that once a receivable is 120 days past due, there is a 20% chance that it will never be collected. The collection rate erodes further as additional time goes by. As we have shown elsewhere in this issue, policy changes that speed the turning of receivables into cash can generate immediate, permanent and, in some cases, substantial tax-free cash flow.

A good place to start may be by offering your customers an incentive for early payment of invoices. Offering a 1% discount on the total invoice amount if payment is received within 10 days and your typical terms are net 30 days, would be referred to as “1/10, net 30.”

How to analyze the cost or savings of offering an early-pay discount

First, answer these three questions: What does it cost your company to borrow for short-term needs? For our example, let’s assume 8.5% annually. What is the risk of non-collection on receivables due from companies that you expect to take advantage of the early-pay discount offer? For our example, let’s assume our average annual bad-debt expense is 2% of revenues, but that our answer to this question is 1.5%, because we expect that customers who take the early-pay option will be the more financially stable ones. How many days sooner will the “early payers” pay? Let’s assume 35 days.

Now calculate your discount rate by adding your annual borrowing rate (8.5%) to the estimate of what your annual losses would be on regular receivables due from early-pay customers (1.5%). The answer for our example is 10%. Next, calculate the daily rate by dividing the discount rate by 365, then multiply the result by the days saved (35 for our example). The answer for our example is 0.009589%. This means that if we want to break even financially by offering the early-pay discount, we should offer only a 0.96% (basically 1%) discount on each invoice. If we round this number up to 1%, we can surmise that the proposed policy would have little effect economically. But some other things should be considered.

First, the early-pay option may be of significant value to certain customers or prospects. As such, it could help you win business. Second, consider the time, effort and money spent on collecting receivables. Although this burden is real, we did not factor this savings into our analysis above. Third, a case could be made to use a much higher cost of capital. This argument is based on the fact that long-term capital, debt and equity can cost 15% or more on a blended basis. If the proposed policy change generates a permanent cash impact, the **long-term** cost of capital should be used and would justify a higher early-pay discount.

To implement: Simply print a notice prominently on each invoice that the customer may take a certain percentage off if he or she pays within the early-pay period. Announce the new policy to the appropriate authority at your customer’s company, too.

Warning: Before you implement an early-pay discount, decide how you will respond if a vendor takes the discount but does not pay early. What if your largest vendor does this? As with any rule or policy, it is only of value if enforced. We recommend that when you announce your new early-pay discount policy, make it clear when and how the discount will be earned and applied. It should be earned when payment is received within the specified period **and** the discount is requested with the payment. If a discount is taken but payment is not received within the allotted time, immediately notify the vendor of the failure to qualify and the outstanding amount. The longer you let the issue wait, the harder it will get to be paid.

Here’s the calculation:

Current annual rate of interest incurred on short-term borrowing: 8.5%

Annual percentage collection loss on customers that we expect to take the early-pay discount: 1.5%

Average days that it currently takes to collect on trade sales (receivables) and the customers that will likely take advantage of the early-pay discount: 45

Early-pay discount to be given if credit sale is paid within a certain number of days? 10%

Discount rate $= 8.5\% + 1.5\% = 10\% \text{ or } .10$

Daily rate $= \frac{\text{Discount Rate}}{365} = \frac{.10}{365} = .000274$

Break-even discount $= \text{Daily Rate} \times \text{Days Saved}$

$= .000274 \times (45 - 10)$

$= .000274 \times 35$

$= .009589$

$= .96\% \text{ or} \sim 1\%$ ❑

***Getting Paid: Sound Credit Policy and Collection Procedures*, continued from page 9**

10 days of invoice date. For more, read “Accelerate Cash Flow: Offer an Early-Pay Discount?” above.

Bringing it all together: Credit policy and collection procedures can make or break a company. The best systems are both smart and savvy. Use this article to establish smart systems that put you in the best possible position to get paid. Then read “Maximize Receivables Collection Without Alienating Customers” on page 10 to incorporate the savvy. Be sure your new policies and procedures are integrated into the operations of your company, and train your employees about their implementation and importance. Discipline yourself to enforce them and demand that others in your organization adhere to them. Together, you will have a system that will keep collection loss to a minimum, especially during difficult economic times when collection problems become more prevalent. ❑

A Simple Skill That Can Dramatically Improve Your Life

I recently completed a course titled *Mergers and Acquisitions* (M&A) offered at the Aresty Institute of Executive Education, The Wharton School, University of Pennsylvania. My purpose was to brush up on my financial analysis skills for my M&A advisory practice. But to my delight, I got more than that. One of the areas of unexpected benefit was a section on "negotiation." It was titled "Negotiations for Competitive Advantage" and was taught by Professor Stuart Diamond.

Diamond argued that while many people and organizations focus on financial aspects of transactions, the spoils go inordinately to those equally skilled in the art and science of negotiation.

Diamond argued that while many people and organizations focus on financial aspects of transactions, the spoils go inordinately to those equally skilled in the art and science of negotiation.

Diamond's sessions included lectures, case studies and group exercises. He promised that if we incorporated some of the competencies into our lives (negotiation is about everyday life, not just business), we'd enjoy a lifetime of returns. I'm sharing them here in case you want to incorporate them into your life and work.

Develop trust. Trust is an essential element for trade. Without it, parties would either not trade (negotiate) or would spend inordinate amounts of time protecting themselves against betrayal. As a negotiator — and you ARE a negotiator — the most significant asset you have is your reputation for trustworthiness. Build it. Protect it. Don't ever betray it. Then profit from it.

Defuse tension and reduce stress. People don't negotiate well under stress and/or discomfort. They withdraw, remain distracted, and outcomes are often suboptimal for all parties. So pay attention to the negotiating party's state of mind. Arrange for comfortable surroundings. Make everyone feel relaxed and at home.

Expand the pie. Diamond continually urged us to consider how to "expand the pie," in other words, create a win/win. All negotiating parties benefit from a bigger pie because then there is more for everyone.

Information is power. Gather information at every opportunity. Dig deep. Role-play. Ask questions:

If you were me, what would you be most concerned with?

If you were me, what would you be most interested in?

What do I need to know to give you what you really want?

What, if anything, am I missing?

If you had your wish, what would you add or take away from this negotiation?

Think these questions won't get you good answers? Think again. Develop an environment of trust and you'll get meaningful information.

Forget the past and things you can't control. In most negotiations, you can't change the past. All you can do is impact the future. The past is dead and gone. All that matters is what you can do together today to improve the future for both of you. Of course, you can deal only with things within your control. So focus on those — get them all out on the table — and work out a deal that makes you both better off than you would be otherwise.

Standards. One way to get the other party to agree with you is to use a standard — a set of rules or principles that guide decision-making. It might be a principle that your counterpart has adhered to in the past or can agree to today. For example:

- We're going to put the past behind us and start anew.
- We're not going to worry about what we can't control.
- All we care about is how much money we both make (or save) on this deal.

Get off your high horse. Negotiating is not about who is right or wrong. It's simply about what we should do now. It's about getting what you want by giving them what they want. Who cares whether you agree, philosophically or otherwise? If you are hung up on being right, you won't be a good negotiator.

Don't let your behavior get in the way. In difficult negotiations, take care not to lose your cool. If someone becomes irate or rude, remain calm and respectful. Throw a tantrum, say something stupid or act inappropriately, and you'll likely not get what you want.

Expand the time frame of the negotiation. It's not over until you say it is. You haven't failed until you've quit. So be patient and persistent. Keep communicating. As long as you stay in the game and keep communicating, investigating, offering trades, listening and checking, there's hope.

Expand the time frame of the relationship. Goodwill, fairness and generosity should play a part in your negotiation. One way to establish this is to talk about connections the two of you enjoy, personally or organizationally. What's the history? Review it fondly, as far back as it goes. How about the future? Successful negotiations today can lead to fruitful, mutually beneficial relationships. Don't feel that what we do today matters only for today. It's much bigger than that. Relationships are important and can last for generations.

Make friends, not enemies. Get close. Build trust. Cooperate. Work together. Meet each other's needs. Build bridges, don't burn them.

Use power subtly. People don't respond well to force. Successful negotiations occur when all parties feel a sense of

continued on next page

A Simple Skill That Can Dramatically Improve Your Life, continued from previous page

mutual cooperation. Playing the power game is risky and often results in suboptimal outcomes.

When you've come to deal, the more chips the better. Good negotiators don't mind complexity. In fact, they thrive on it. More complexity leaves more room for win-win combinations. So as you prepare for a negotiation, get all the issues and possibilities out on the table.

Frame your goals in the interests of your counterpart. Tell them why something is in their best interest, based on their goals, and you'll have a better chance of getting them to agree to what you want. You are the least important person in the negotiation. Of course, your goal is to satisfy your own needs, but you won't get very far if you don't focus on understanding your counterpart's goals and needs, and figuring out how to satisfy them while satisfying your own. Said another way, get out of the win-lose mentality.

There's a lot more in a deal than money. Diamond tried to help me realize that we often have a lot more to trade than typical terms of a sale agreement. My task is to discover what my counterpart wants that would not cost me much. An introduction to someone? A reference? Exposure in my publication? Help with solving a problem?

I went to Wharton to brush up on my financial acumen. I returned with a clear sense that by becoming a more skilled and effective negotiator I could garner more for myself, my family, my employees, my partners and my clients. You can, too.

Each day, you negotiate: where to go for dinner, how to resolve a family spat, children's allowances, caring for an elderly parent, car repairs, employee compensation, product returns, vendor credit terms, and so forth. Logically, if you improve the outcome of each negotiation — whether the outcome is happier participants, better relationships or better terms for you and yours — the cumulative impact on your life, and the lives of those around you, would be considerable. ❑

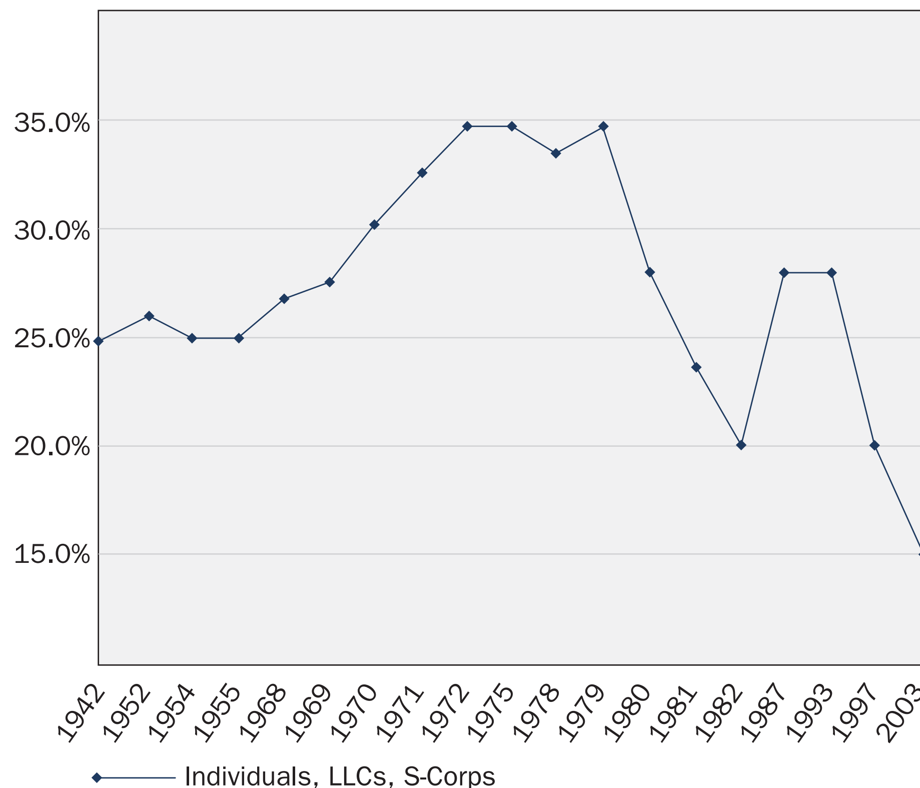
How to Protect Yourself from the Coming Capital Gains Rate Hike

Capital gains rates have been at historic lows since 2003. The result has been slim tax bills enjoyed by investors who have sold and taken gains, and record U.S. federal budget deficits.

The deficit, running at about $1.4 billion per day, is not entirely the result of lower capital gains rates, but it will have to be reduced somehow — and soon. President Bush will not raise taxes before he departs next January, so the task will be left to the next administration/Congress. Looking at the adjacent chart of historical long-term capital gains rates, it seems too easy for Congress to try to reduce the deficit, in part by raising capital gains rates to a level more in line with historical rates.

If I were a betting man, I'd wager that it's coming. Rates will rise by 2010 unless Congress enacts new legislation, probably 100% (given the deficit).

What can you do about it? Pretty simple. Take your gains now. That is, if you plan to sell an asset that has appreciated in value, do it before the tax law changes. If you sell a business and take a $1 million gain, the current 15% long-term rate means your tax bill will be $150,000. If the rate rises to 25%, your bill will be $100,000 more. That's a lot of dough. ❑



What You Need to Know About Appraisals

Contrary to what some people believe, an appraisal does not give the value of an asset. Given the important role appraisals play in our economic world today, taking this to heart could very well save you a lot of money one day.

Many appraisals are not worth the paper they are written on. So to help you build a framework to more accurately understand appraisals of any type of asset — real estate, autos, boats, jewelry and businesses — here are two important things you need to know:

1. An appraisal does not provide the value of an asset, but rather a person's opinion of the value of an asset. The following are as important as the appraisal itself:
   a. Experience of the appraiser, including recent experience appraising assets similar to that of the subject.
   b. Formal education of the appraiser, including specialized training in appraisal.
   c. Methodologies used in performing the appraisal at issue. The appraisal report should clearly describe the data gathered and considered and the analysis conducted, so that the reader of the report can follow and understand.
   d. What methodologies could have been used but were not, and why.
   e. What assumptions were made and how might they have impacted the conclusion.
   f. How the final value was determined.
   g. Whether the appraisal was performed and value conclusion rendered in an arm's-length manner in all respects, or whether the appraiser might be biased in some manner.
2. Generally, anyone can legally offer his/her services as an appraiser. But organizations that rely on appraisals, such as lending institutions and the Internal Revenue Service (IRS), will often establish qualifications that appraisers must meet.

For example, IRS requires that a "qualified" appraisal be obtained to substantiate any non-cash deduction claimed for more than $5,000. IRS defines a "qualified appraisal" as one conducted by a "qualified appraiser" in accordance with generally accepted appraisal standards.

A "qualified appraiser":

- Has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary of the U.S. Treasury.
- Regularly performs appraisals that he/she receives compensation for.
- Meets such other requirements as may be prescribed by the Secretary of the U.S. Treasury in regulations or other guidance.

Critical to understanding the value conclusion in an appraisal is to understand the definition of value used by the appraiser for the appraisal. Typically, the definition will be fair market value (FMV). You should review the definition. It is specific and informative:

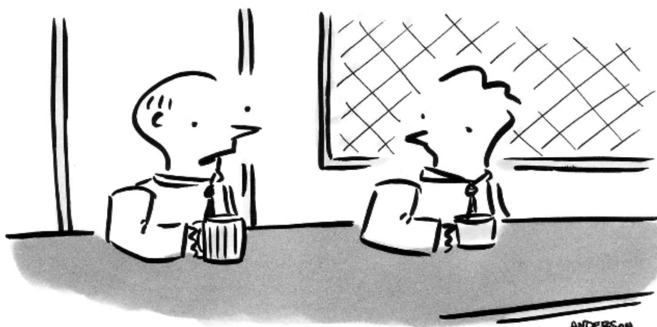
Fair market value (FMV) is the price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.

Example 1: If you give used clothing to the Salvation Army, FMV would be the price that typical buyers actually pay for clothing of this age, condition, style and use. Usually, such items are worth far less than what you paid for them.

An appraisal does not provide the value of an asset, but rather a person's opinion of the value of an asset.

Example 2: If you donate land and restrict its use to agricultural purposes, you must appraise the land at its value for agricultural purposes, even though it would have a higher FMV if it were not restricted.

Whether you are obtaining an appraisal for yourself or interpreting one provided to you on a business matter, keep these things in mind, particularly that the appraisal is just one person's opinion of value and that the appraiser's opinion is never more valid than the facts it is based on. Without a disciplined review of relevant facts, the appraisal opinion is simply a guess. ❑



"How much is two birds in the bush in your hand *worth?"*

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Incremental Cost Analysis: A Quick Way to Save Money on Quantity Purchases

This simple analysis can save you a lot of money when buying inventory in quantity.

Analyze your incremental costs at different quantity levels when you purchase in volume. It takes only a few minutes and makes it clear which order volume will give you the best per-unit price and the most savings.

To illustrate, let's assume you order 1,000 widgets every quarter and your supplier just faxed you the following price quotation (Table 1):

Quantity	Total Cost	Average Cost Per Unit
1,000	$2,850	$2.85
2,000	$5,250	$2.63
3,000	$7,150	$2.38
4,000	$9,050	$2.26

From the quote provided by your supplier, let's add two more columns: incremental cost and incremental cost per unit. These data will show you much more than the average cost-per-unit data provided by your supplier.

Complete the Total Incremental Cost Column

To calculate total incremental (additional) cost for an additional 1,000 units after the first 1,000 widgets, simply subtract total cost quoted for 1,000 units ($2,850) from total cost shown for 2,000 units ($5,250). The difference is $2,400, which is the incremental cost of an additional 1,000 units (after the first 1,000 ordered). Now do the same for the third 1,000 units ($7,150 minus $5,250 equals $1,900) and the fourth 1,000 units ($9,050 minus $7,150 equals $1,900). Great! You've completed the Total Incremental Cost column.

Complete the Incremental Cost Per Unit Column

To complete the second supplemental column, simply divide incremental cost by additional units to get your incremental cost (in our case, additional units are 1,000 in each case). So for the second 1,000 units, incremental cost per unit is 1,000 divided by 2,400 or $2.40 per unit. The third 1,000 is $1.90 per unit, as is the fourth (Table 2).

Quantity	Incremental Cost	Incremental Cost Per Unit
1,000	N/A	$2.85
2,000	$2,400	$2.40
3,000	$1,900	$1.90
4,000	$1,900	$1.90

At the 3,000-unit level, your incremental cost per unit is $1.90. Compared to cost at the 1,000 level, you can save $0.95 per unit ($2.85 less $1.90), which is a savings of 33% ($0.95 divided by $2.85). Thus, you should consider ordering 3,000 units to get the 33% savings.

If you use only average cost data, which drops every 1,000 units, you would not have sufficient information to make a prudent decision on which volume is the best buy. For example, the $1.90 incremental cost at the 3,000-unit level is below your average cost of $2.38 at the 3,000-unit level. So the 3,000-unit order is a much better buy than the average cost figures would indicate. You save $0.48 per unit or 25%.

Now compare the 3,000 and 4,000 quantity levels in Table 1. Your average cost is lower with a 4,000-unit order ($2.26 vs. $2.38 for 3,000 units). But that's deceptive. The incremental cost of $1.90 (Table 2) is exactly the same for both levels. Increasing your order to 4,000 units isn't necessary because there are no additional per-unit savings by ordering 1,000 more units. So why tie up your capital with excess inventory?

What You Can Do

Refer this advisory to your purchasing department. It should be calculating its own supplemental columns for volume purchases. If your suppliers are not giving you price quotes at different quantity levels, ask them to do so. You will find them receptive because they like to sell in volume. And you might find that their volume price breaks provide an opportunity for you to save some money. Of course, before you buy in bulk, consider other things, such as cash flow and inventory obsolescence/spoilage issues, but at least now — with the incremental cost-analysis tool — you'll be armed with better financial decision-making data. ❑

FAMILY-OWNED BUSINESSES

Oldest Family Business in the United States

Company Name: Zildjian Cymbal Co.

Founded: 1623

Family Name: Zildjian

Product or Service: Cymbal manufacturing

Location: Norwell, Mass.

Website: www.zildjian.com

Founded 14 generations ago in Constantinople by alchemist Avedis I, who discovered an extremely musical alloy that created powerful, durable cymbals. The sultan named him "Zildjian," Armenian for "cymbalsmith." The family emigrated to the U.S. in 1929. Avedis Zildjian III established ties with the hot, new jazz drummers of the 30s and 40s. His son Armand (1921 – 2002) modernized the manufacturing process and factory. Today, Armand's daughters Craigie (CEO) and Debbie (vice president) run the company.

Note: A family business is dominated or controlled by members of a single family (or single family lineage).

Oldest and Largest U.S. Family Businesses:

- Cargill, Inc., Cargill/MacMillan family, founded 1865, commodities trading, Minneapolis, 97,000 employees
- Levi Strauss, Haas family, founded 1853, apparel, San Francisco, 40,000 employees
- Bacardi, Bacardi family, founded 1862, rum, 7,000 employees
- Crane & Co., Crane family, founded 1801, paper manufacturing, 1,200 employees

Source: Family Business Magazine ❑

What Every Business Seller Should Know

SELLING A COMPANY | **BUYING A COMPANY** | **BUSINESS VALUATION**

Financially, you would be better off keeping your business. If, despite this, you think it is the right time for you to sell all or part of your company, Acquisition Advisors can advise you on your options and help you make the right choice.

To be sure, it's an important decision. You need an advisor who has extensive experience putting deals together, understands the complexities of selling a business and shares your goals.

Acquisition Advisors recently completed four transactions in the manufacturing sector, ranging from $3.5 million to $110 million (case studies available on our website).

Our clients have found engaging Acquisition Advisors ensures multiple offers at premium prices without wasting time with unqualified buyers. Clients hire us for our expertise, honesty and work ethic.

You can find free articles, information and case studies at www.AcquisitionAdvisors.com. Or give us a call. Strictly confidential.

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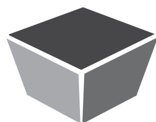

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