

June 16, 2015

INVESTMENT LETTER

Intuit, Inc. (Nasdaq: INTU): Creating software to make keeping records and filing taxes easier for millions of taxpayers every year

The Internal Revenue Service (the IRS) has an annual budget that exceeds eleven billion dollars, and a deep work force of 82,600 employees, and collects, without much resistance, trillions of dollars each year for the federal government.

There is no debate that the IRS is a powerful institution, capable of enforcing thousands of provisions of the tax code, performing its job with little difficulty.

Table 1. The Federal Tax Code: Longer and More Complex Every Year



The reach of **the IRS** is on the minds of millions of taxpayers, making them pause before considering taking aggressive deductions or omitting income from their annual returns. But when a taxpayer decides that he can outfox **the Internal Revenue Service** he may underestimate the sophistication and efficiency of the agency's audit system, a system that looks for numbers that do not add up. When the agency believes that a taxpayer is guilty of bad behavior, that is when it suspects tax fraud, it has many means to remind an errant taxpayer of who is boss, and who makes the rules when it comes to the issue of taxes. (For a review of **the IRS's** audit methods, see Table 3 on page seven.)

The IRS is neither corrupt nor malevolent. It does not wish to make life difficult for taxpayers. It does not want to intimidate taxpayers. As Table 2 below shows, in fact, **the IRS** audits only a small percentage of taxpayer filings, with the likelihood of an audit rising as a taxpayer's income rises.

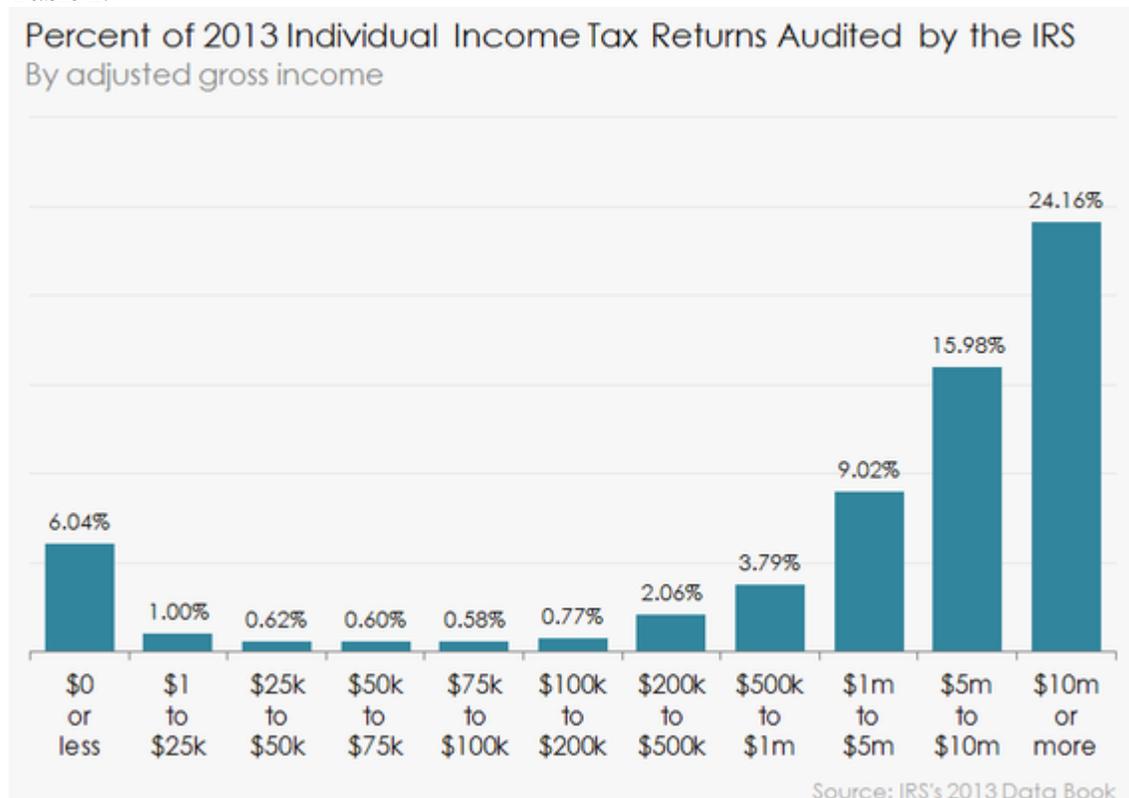
Nevertheless, taxpayers respect the reach of **the IRS** and want as little to do with the agency as possible.

Once Upon a Time

For decades **H&R Block, Inc. (NYSE: HRB)**, which was founded in 1955 and went public in 1962, enjoyed the largest tax preparation market share, each year helping millions of taxpayers, most often people with middle class and lower class incomes, correctly fill out federal and state income tax forms, helping taxpayers reduce the odds that their returns would be audited. (According to Fortune magazine, **Block's** customers, each year, had an average adjusted gross income that was lower than the national one, which, for example, was \$42,000 in 2005.)

It was worthwhile, it was smart, and in fact it was a great bargain to pay **H&R Block's** fee, which for many years was often less than one hundred dollars.

Table 2.



Filing income taxes, H&R Block's clientele believed, was time consuming and anxiety producing. Why not outsource the job of giving the IRS the information it wanted, a job that an H&R Block employee did eight hours a day, pretty much supplying the same information, filling in the same blanks, almost as if the Block employee was on an assembly line, except that it was a one person assembly line? Why worry about tax matters when you had better things to do with your time, time away from the job, time which, contrary to conventional thinking was scarcer than the free time affluent or upper class taxpayers enjoyed? Why waste time, for example, in trying to figure out whether the space you used in your garage in which you freelanced as a mechanic after the official nine to five working hour, was deductible and if it were, was the deduction based on the percentage of square feet that the garage took up as a percentage of household square feet or was the deduction based on the number of hours worked in the garage, or was the deduction based on the percentage of income that the freelance work contributed to total taxpayer income? (Got that?)

Having Block do the tax work, even if the work was not especially complicated but usually consisted of adding wages, income from a certificate deposit, and adding up capital gains and losses, if any, was very calming, especially for those who believed that the IRS was a malevolent entity, waiting to pounce on the smallest error, on any insignificant omission of income.

Before April 15 of each year millions of taxpayers made an appointment with the nearest H&R Block office, got in their car, with all data needed for filing a 1040, data such as medical bills, charitable deductions and W-2 and 1099 forms, and drove to the nearest H&R Block office, of which there were thousands scattered around the country.

There, surrounded by institutional desks and chairs, an H&R Block employee would competently and politely fill out all forms required for filing, making sure to follow all instructions exactly as written.

After leaving the Block office with all income tax forms ready to be filed there was often a great sense of relief, and no less so than leaving a dentist's office having sat in a chair for more than one hour and listened to the high powered drills while the dentist worked diligently to clean a cavity, occasionally and of course inadvertently slipping with the drill and hitting a nerve while she prepared the amalgam to take care of the cavity. (We have a number of clients who are dentists and all of them, I know have excellent bed side or chair side manners.)

Block's clients did not want to have their fees padded so they could visit plush offices, where a well dressed receptionist would greet them, offer coffee and a soft drink, driving up the office overhead, an unnecessary expense that the Bloch brothers, keeping in concert with the low cost bare bones approach that made Sam Walton rich, thought was unnecessary.

Many of Block's clients, in fact, would probably have been uncomfortable with fancy offices. They did not wish to pay for frills. What Block's clients wanted was a fast, inexpensive completion of their tax forms, an insurance policy designed to limit their interaction with the IRS. Their lives were not glamorous and they did not expect the luxurious trappings of a white shoe CPA firm. All they wanted was a good service at a low price. Block understood their clients and the importance of one fact: there have always been and there will always be millions more poor and middle class households in the United States than rich households, and the former cannot afford and do not need expensive tax preparation services.

Once Block figured out how to train people to do tax work, they could take their textbook, as it

were, to thousands of offices around the country. **Block** was similar to **Wal-Mart Stores, Inc.** (NYSE: WMT): take good common sense concepts, know your market, and duplicate these concepts so that efficiency and profit margins grew as the company grew, making the concept of economies of scale come powerfully alive. With its economy of scale formula, **H&R Block** was able to enjoy ownership of the tax preparation market for decades.

Intuit Arrives On the Scene

But things began to change in 1993 when **Intuit** came on the tax scene, offering a software package for doing your taxes, concomitant with the rapidly growing adoption of the personal computer. It seemed that the convergence of **Intuit's** software offering and the dynamic popularity of the personal computers had caught **H&R Block** off guard.

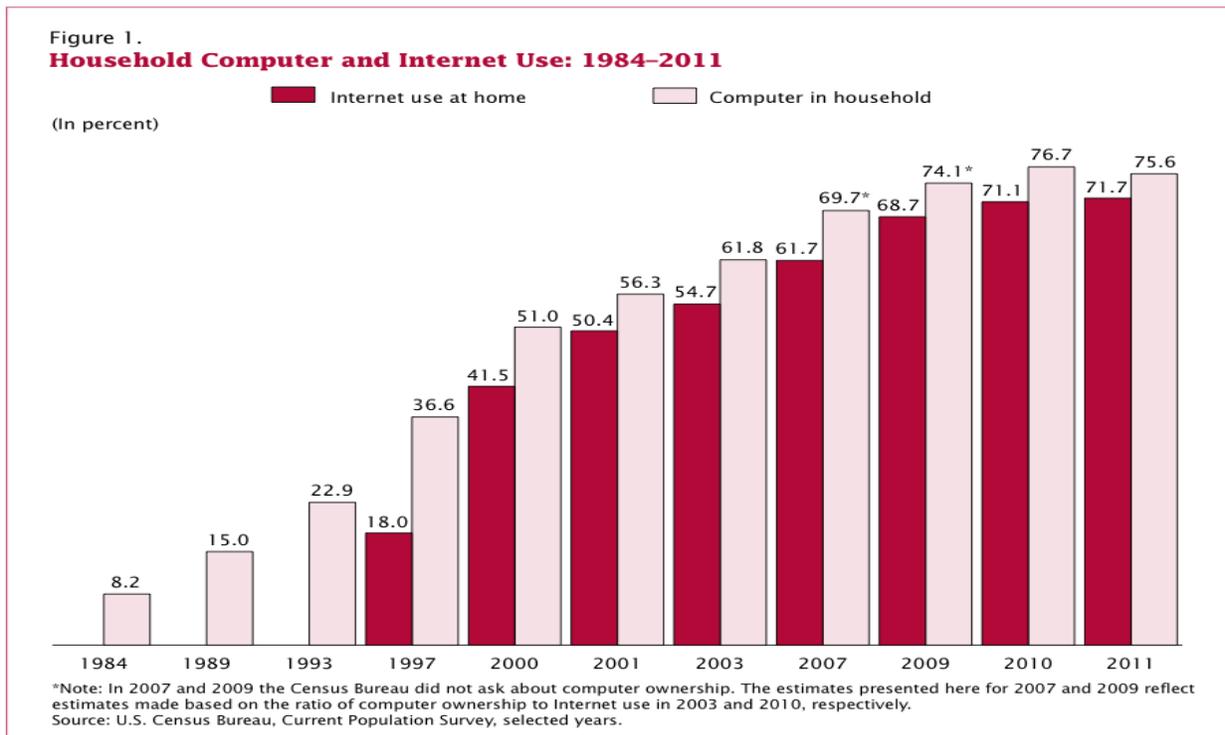
Using a well constructed software program was more convenient and more efficient than visiting an **H&R Block** office. I say more efficient because the software could be programmed to answer

thousands of possible questions, many of which few **Block** personnel could easily answer, if ever. (Later, in 1994, **Block** acquired a tax software package, called TaxCut. But by then **Intuit** had taken a commanding lead in the software tax preparation market.)

Intuit Enjoys the Trend of Increasing Adoption of Computer and Internet Use in the United States

According to the U.S. Census Bureau, computer and internet use at the household level has changed greatly from 1984 through 2011 (Figure 1). In 2011, 75.6 percent of households reported having a computer, compared with only 8.2 percent in 1984, the first year that the Census Bureau asked about computer ownership, and 61.8 percent in 2003, the last time the Census Bureau asked about computers prior to 2010.

Similar shifts occurred for household internet use, as 71.7 percent of households reported accessing the internet in 2011, up from 18.0 percent in 1997, the first year the Census Bureau asked about internet use.



Intuit, Inc. (Nasdaq: INTU): Investment Thesis

First, legally mandated filing to pay taxes will never suffer obsolescence, but beyond that fact, **Intuit** enjoys many competitive advantages, compared to **H&R Block**, its chief competitor, and all tax preparation businesses. Whereas **Intuit** has QuickBooks, which millions of small businesses use to do their accounting and to keep track of all finances, **Block** has no offering for those functions. Second, **Intuit** has Quicken, which provides personal finance tools. Again, **Block** does not have a comparable offering.

Third, not only are **Intuit's** offerings broader per se than the competition, but **Intuit** has also constructed the software of each program so that one program can communicate with the other, and export data to and import data from one program to another. An **Intuit** client may only use one product at first, say TurboTax, but once satisfied with it, she is likely to be receptive to an **Intuit** salesman suggesting that she try QuickBooks. The linking of the software programs does not stop with QuickBooks and TurboTax. For example, users of QuickBooks are likely to adopt **Intuit's** payments and payroll services, and Quicken users are more easily convinced to transfer yearlong financial information into TurboTax.

To see how linking of products is compelling for the **Intuit** client I asked Martin Turnbow, the company's accountant, to describe how he works with the QuickBooks and TurboTax systems. His comments appear below exactly as he wrote them:

QuickBooks is in my experience the easiest accounting software I have utilized.

I find QuickBooks is particularly user friendly in the following areas. The reporting capability provides the option of opening multiple reports on screen without interrupting the current workbook. The reports can be customized and setup to provide more or less details as needed. The program also provides ease of access to previous years' reports. One of my favorite features is the Find feature. This system utilizes any number of variables to narrow down and locate transactions.

The check writing system is very user friendly. The program allows users to sync bank accounts and download bank transactions. This in turn allows the user to match previously recorded transactions with the bank transactions at the click of a button. The billing system is multifaceted offering the user both a printable invoice as well as preparing and sending invoices to each customer by email. The system is easily configured by clicking two or three boxes to produce a mass email of all client invoices for a billing period.

The TurboTax program is equally user friendly. The program pulls all of my expense and income information from the QuickBooks files. The program also remembers my information from year to year preventing the time consuming task of reentering addresses and personal information for W-2's, charitable giving, and bank information.

TurboTax also provides a step by step guide through the tax process or the option of guiding me through the process with easy to follow menus. The system accounts for every question and scenario I may encounter. I can read through the help screens in each section to be sure every income and deduction area is fully understood as needed. The program thoroughly evaluates the return before completion for errors and/or audit risks.

Intuit, Inc. (NASDAQ: INTU): Investment Thesis (Continued)

Once satisfied with QuickBooks and TurboTax, Intuit now enjoys greater ‘stickiness’ with the client: to make a change now with two products in use will be more demanding of time and energy and reeducation, than just making a change with one system because data or information in one system has been integrated with information in another system, and the method of taking the client through one step in a software program in QuickBooks is almost identical to the instruction system of TurboTax. Finally, learning any new system takes time, money and energy.

Fourth, Intuit has moved quickly into the cloud, so that it can offer small businesses, for example, services from its partners, such as American Express (NYSE: AXP), PayPal, Salesforce.com, inc. (NYSE: CRM) and Square. Competitors have few cloud offerings. Moving quickly into the cloud, and spending significant research and development on building a cloud business is reflective of Intuit’s belief that a company must be alert to the reality changing market dynamics.

Fifth, Intuit has the cash flow to fund annual substantial outlays for research and development. Intuit’s management is alert to the reality, especially in the worlds of software and technology, of changing dynamics of markets, and the company has made the recognition of that reality an indispensable part of its culture. Intuit’s research and development expenses were \$758 million, 17% of net revenue in fiscal 2014; \$685 million, 17% of net revenue in fiscal 2013; and \$618 million or 16% of net revenue in fiscal 2012.

Not only does this amount of spending improve its offerings every year but it reminds me of what Facebook, Inc. (Nasdaq: FB)’s founder and CEO said about business and competitive survival, especially when software is involved: “...to survive and beat the competition, you better be paranoid.” Perhaps Zuckerberg exaggerates the mindset for business survival, but surely it is better to be alert, and even hyper vigilant, instead of complacent, believing incorrectly that the competition is not spending a considerable amount of its time, money, and energy to unseat you.

Intuit, Inc. (NASDAQ: INTU)

Selected Financial Statement

For the fiscal year ended on July 31

(Dollars in millions, except per share amounts)

	2010	2011	2012	2013	2014
Sales	\$3,091	\$3,449	\$3,808	\$4,171	\$4,506
Diluted Earnings per Share	\$1.77	\$2.00	\$2.60	\$2.83	\$3.12
Dividends per Share	-	-	\$0.60	\$0.68	\$0.76
Capital Expenditures	\$130	\$213	\$186	\$195	\$186
Free Cash Flow	\$868	\$800	\$1,060	\$1,171	\$1,260

Table 3.

This table gives the hows and whys of an **IRS** audit. Reading of this box is only for those with at least one of the following: great reading stamina, unusually powerful concentration, and some dimensions of obsessive compulsive personality qualities, and of course some strong coffee.

There are several different methods used to select individuals and businesses for examination, according to Wikipedia.

Third party documentation: Employers and financial institutions, among other organizations, are required by law to send documentation (W-2's and 1099's, for example) to **the IRS**. **The IRS** uses software to ensure that the numbers on a tax return match the numbers they receive from third parties. If the documentation does not match, the return will be examined.

DIF score: When a tax return is filed, **the IRS** uses computer software called the Discriminant Index Function System (DIF) to analyze the return for oddities and discrepancies. Once the return has been processed through DIF, it is given a score. If the DIF score is high enough (i.e. a large amount of oddities or discrepancies are found), that tax return may be selected for examination. The formulas the IRS use to create the DIF software and analysis are a closely guarded secret.

UIDIF score: Tax returns that are filed are also subjected to an evaluation called the UIDIF, or the Unreported Income Discriminant Function System. This system analyzes tax returns based on a series of factors to determine a tax return's potential for unreported income. Likewise, along with the DIF score, returns that are found to have a high UIDIF score (i.e. the likelihood of unreported income) may be selected for examination. The IRS formulas used to calculate UIDIF are secretive, but it is commonly thought that the IRS uses statistical comparisons between returns to determine UIDIF potential.

Random selection: **The IRS** selects a certain amount of income tax returns to be audited each year through random selection. No errors need to be found for the Enforcement branch to examine a tax return. Random selection exams tend to be more extensive and time-consuming than other forms of review.

Sincerely,



Fredric E. Russell

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Fredric E. Russell has a B.A. from **Swarthmore College** in Swarthmore, PA and an M.B.A and an M.A. from **Washington University** in St. Louis, MO. He also holds the CPA certificate and, in his

previous life, he taught accounting and finance at three universities, as well as history and literature at one university. He believes that his love for writing and his usually correct grammar come from spending four years learning the English language at **Deerfield Academy** in Deerfield, MA, and from spending countless hours in the **Swarthmore College** library on Saturday afternoon studying great writers in history and philosophy while wishing he were at a big university, such as **the University of Oklahoma**, watching a football game on Saturday afternoon with women who enjoyed partying as well as studying, a dual

dynamic missing at [Swarthmore](#). He likes to read anything well written that he can find. He does not enjoy fiddling with an iPhone but prefers to use his work and spare time studying and collaborating with his driven, sharp colleagues to produce letters that are informative and easy to read. BUT MOST IMPORTANTLY OUR JOB IS TO MAKE MONEY WITH LITTLE RISK AS POSSIBLE FOR OUR CLIENTS. We are appreciative of a wonderful client base and I am appreciative of being able to come to work each day and be with highly intelligent and pleasant coworkers.

[Ying Qi](#) and [Qian Zhang](#) helped me tremendously with this letter. In their own words below, they tell you a little bit about themselves.

[Ying Qi](#) was born and raised in the City of Baotou, Inner Mongolia, China. She holds a bachelor degree in Social Work from the [Beijing Institute of Technology](#) in Beijing, China. Her experience includes marketing & data analytics and systems management. She worked as Administrative Secretary and Assistant to the Asia-Pacific Vice President of Emerson Process Management, a division of Emerson Electric. Ying joined the firm since July 2013, and has been on a wild journey to the world of finance ever since. Her system management background enables her to help the firm to develop a more organized and efficient operation system, together with Qian and Martin to better serve our dear clients. When she is not at the firm, you will find her a patron “Gym Animal” at St. John Health Club, a passionate home cook, and many other things. Ying has been happily married to Ben Anderson for four years and counting. Ben graduated from the [University of Washington](#).

[Qian Zhang](#) was born in the City of Langfang, Hebei province, China. She holds a master’s degree in finance from the [University of Tulsa](#). She has an undergraduate degree from [Hebei](#)

[University of Economics and Business](#) in Shijiazhuang, China. She met her husband, Shu Luo, when they both studied at the [University of Tulsa](#). Shu holds a Ph.D. degree and a master degree in petroleum engineering from the [University of Tulsa](#). Qian joined the Fredric E. Russell Investment Management Co. since 2012. Qian assists Fred with investment management, constructively challenging Fred’s ideas on the deployment of cash, and in so doing reminds Fred of what Warren Buffet has said about Charlie Munger, whom Buffett greatly admires and who is his right hand man at [Berkshire Hathaway, Inc. \(NYSE: BRK/B\)](#). One of Munger’s jobs is to temper Buffet’s enthusiasm when he senses that Buffet has become too excited, too optimistic about an investment’s prospects, playing this role so well, that is with firmness yet with deep respect, guiding Buffett’s energy, imagination, and optimism to positive channels, that Buffet has termed Munger, with great affection, the “abominable no man.” Fred gives Qian a nickname “abominable no woman.”

For further information: contact [Ying Qi](#), [Qian Zhang](#), or [Christopher Reavis](#) at their respective email addresses: yqi@ferimc.com, qzhang@ferimc.com, or clr@ferimc.com; or our office: 918-743-5959.

Our web site: www.ferimc.com has loads of information about the firm including an archive of Investment Letters. Clients and employees (through taxable accounts and through the Fredric E. Russell Investment Management Co. 401(k) Plan) own, as of June 15, **70,565 shares** of [Intuit, Inc. \(Nasdaq: INTU\)](#). We may liquidate, decrease, or increase our position in [Intuit, Inc.](#) at any time, without notice before or after we do so. This letter is not a recommendation of purchase or other action.

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