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CLIENT'S tax & financial UPDATE

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A tax, business, and financial planning newsletter for our clients and friends

How Banks Use Financial Ratios To Measure Your Performance

When bankers and other lenders look at your company's financial statements, they use financial ratios to quickly develop a profile of your business. An understanding of the most common of these ratios cannot only help you in your dealings with your banker, but it can also be a valuable tool to help you manage your business better.

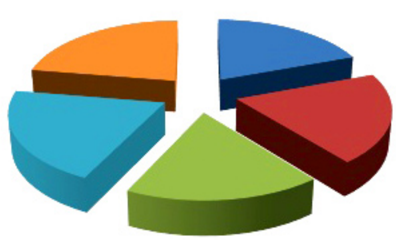
To assess your performance, bankers compare your financial ratios to those of other companies in your industry, so whether your ratios are good or bad depends on the type of business you are in.

Of the dozens of financial ratios that can be computed, here are the nine that many bankers, accountants and business executives consider the most meaningful.

1. **Current assets to current liabilities.** This ratio is also called a "current ratio". It is an indicator of your company's ability to pay debts that are due within a year. In calculating this ratio, "current" assets mean "liquid" assets such as cash, receivables, inventory, and marketable securities. Many lenders consider this ratio the most important of all and look for a current ratio of at least 1-1/2:1.

2. **Net after tax profits to tangible net worth.** This ratio is an important indication of profitability and of how well you manage your business, because it measures return on investment. A high percentage return on investment is an important sign that a business is healthy.

3. **Average collection period of receivables.** By dividing accounts receivable by average credit sales



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taxPOINTS

Consult before you sign. During an IRS audit examination, the IRS may ask you to sign an extension of time of the statute of limitation for completing your audit. Before signing, restrict the extension to only those items that are still in question. Otherwise, the IRS agent is free to expand the scope of the audit.

Good Samaritan tax shelter: Charitable remainder trusts. These types of trusts offer substantial tax benefits for individuals who want to donate to a charity. You receive from the trust an income for life, and upon your death the assets of the trust are given to the charity that you have selected.

Money saver. Restructure debt. Low interest rates are an incentive to refinance old debt as well as providing tax benefits. Interest on consumer debt cannot be deducted, but mortgage interest (within limits), business interest, and investment interest up to investment income is deductible. **Strategy:** Refinance high interest, non-deductible consumer debt with low interest fully deductible debt.

Loophole: Inherited property. Property that you inherit as a beneficiary receives a step up in basis to its value at the time of the donor's death or at the value listed on the estate's tax return for estate tax purposes. **Example:** You inherit a piece of real estate that has a cost or tax basis of $50,000, which is worth $150,000 at the donor's death – there is no taxable gain should you sell the property for its value of $150,000.

Avoiding The Deduction Limit On Automobile Business Expenses

Under the tax law rules, your taxes could be unexpectedly higher when you use a car for business, whether you or your company own the car. With proper planning, however, you can maximize your car expense deduction and minimize income taxes on your personal use of the car.

The key to this strategy is to keep detailed records of your business use of the car. This can save taxes in two ways. First, it can avoid the rule that prohibits the deduction of car expenses on a personal return to the extent that they do not exceed 2% of your Adjusted Gross Income. Second, it can keep the value of the vehicle from being included in your personal taxable income.

Here's what do do

Auto expenses should not be paid to you as allowances. They should be paid only as reimbursements for specified business expenses. This means you must give your company an itemized report of your business driving that includes mileage, tolls and parking costs, the cost of gas and oil, and all other costs. The company must then either reimburse you for actual costs or pay you at a rate that does not exceed $.535 per mile.

Under this arrangement auto reimbursements are not included as income on your tax return and you avoid the 2% of Adjusted Gross Income limitation on the deduction of employee auto expenses. Furthermore, because you have established the exact amount of the business use of the car, only the personal use portion of the car's value can be considered as income.

Caution: To use this strategy, regular and accurately detailed expense reports are a must.

Tax Tip

Be sure to report property thefts to the police

You can take a tax deduction for property which is stolen from you, but property which you lose because you misplaced it is not deductible. To guard against improper theft deduction for property which was actually lost, the IRS will usually ask for proof that the property was stolen. If you report all thefts to the police, the police record is your proof that the property was stolen.

What To Do When A Hobby Becomes A Business

Sometimes, what starts out as a hobby becomes a profitable business. However, if the IRS claims that the business is only a hobby, you can find yourself in an unpleasant tax situation:

- You must pay taxes on income from a hobby, but you can't deduct any losses.
- You can't take a home office deduction for a hobby, but you can deduct home office expenses (within limitations) for a business you conduct from your home. The test of whether your activities are a hobby or a business is whether you intended to make a profit. To prove that you intended to make a profit, you should be able to show the following:

- What you charge should be enough to cover your variable costs (supplies, the value of your time, etc.) even if your charges are not enough to meet your fixed costs (rent, etc.).
- You work regularly at your business, not just when you feel like it.
- Your prospective customers know you're in business.
- Your expectations for profit are realistic because you understand your business.

A few ways to show you're really in business are to advertise, to purchase business cards and stationery, to keep accurate business records, to open a business bank account, and to register your business name.

If you show a profit in any three of five consecutive years, that's usually enough proof that your activities are primarily to show a profit. But even if you can't meet that test, you can still prove you *intended* to make a profit.

How The IRS Decides What Returns To Audit

It's rumored that only twelve key employees in the IRS know the formula that is used to determine which income tax returns to select for an audit. However, a review of IRS manuals indicates that there are specific characteristics in a tax return that give it "good audit potential".

IRS computers identify more returns for possible audit than IRS auditors can possible handle, so the final selection of a return to be audited is determined by IRS classifiers. In some cases, these returns are selected at random, but in many instances they are chosen because unusual characteristics in a return indicate further investigation. Here are some examples of "audit potential" characteristics:

- The relative size of a deduction, such as a $30,000 entertainment deduction for a business with gross sales of $300,000.
- The nature of a deduction, such as air travel for an electrician.
- Contradictory information, such as a deduction for mortgage interest but no deduction for real estate taxes.
- Missing information or schedules which can imply an intent to mislead.

IRS classifiers are also influenced by the "professional" appearance of a return. Certain borderline deductions might escape an audit if the return looks like it is professionally prepared.

Tax Planning

Invest In Tax Shelter Annuities which provide for guaranteed minimum death benefits and allow you to funnel money to your beneficiaries without going through probate.

Added Benefit: Earnings grow tax free until you begin taking withdrawals at age 59 ½ or later.

Early withdrawals are subject to a 10% penalty.

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per day, you can calculate your average collection period in days. This will tell you the extent to which your operating capital is tied up in receivables. For example, if your average collection period is 80 days and your credit terms are 30 days, your collection procedures may need improvement or some of your larger customers may be well past due.

4. **Inventory turnover.** By dividing cost of sales or materials by average inventory in a given time period, you can determine how many times your inventory has turned over. A low turnover implies poor sales and, therefore, excess inventory. A high ratio implies either strong sales or ineffective buying.

5. **Fixed assets to tangible net worth.** This ratio shows what portion of your capital is tied up in plant and equipment and, therefore, is not available for operating capital or for payment of debts. It is a measure of the liquidity of your company's net worth.

6. **Total debt to tangible net worth.** This ratio is often critical to bankers because if your company's total debt is greater than its tangible net worth, your business is considered to be undercapitalized. Inadequate capitalization is usually a red flag to a loan officer.

7. **Current liabilities to tangible net worth.** This is the ratio of what your company currently owes to what it actually owns (excluding intagible assets such as goodwill and patents). If this ratio is more than 80%, many bankers consider it a negative indication of the company's financial condition.

8. **Tangible net worth turnover.** By dividing net sales by tangible net worth, you can determine how many sales dollars are generated by each dollar of tangible net worth. Naturally, the higher the turnover, the better the company is performing.

9. **Working capital turnover.** This ratio is determined by dividing net sales by net working capital. It determines how many sales dollars are generated by each dollar of working capital. If your turnover of working capital is low (five times, for example), your use of working capital is probably unprofitable.

The significance of many financial ratios varies from business to business. You should consult with your accountant to determine the proper application of financial ratios in the management of your business.

Security Tips

Office computer protection

The most effective way to prevent the theft of office computers and computer components is to lock them to their furniture, which is usually too large and too heavy to be moved. Cable locks that connect components to each other and to desks are often enough to foil casual thieves.

The best protection, however, is full-sized metal baseplates that can be attached between computer components and desks. Although they are more costly than cable locks, they provide the highest degree of security. In fact, some manufacturers of these devices will pay users of their security systems for any loss from theft.

Spotting fake checks

The first two digits of the account number printed at the bottom left of a check are the Federal Reserve Bank code for the state in which the issuing bank is located. Professional forgers know this and often print checks with an incorrect location code to delay the processing of a check.

For example, if a criminal prints phony checks for a Massachusetts bank and uses the bank location code for Oregon, it will take extra time for the check to reach the bank. The check forger uses this time to move on to another city. Lists of location codes are available from any Federal Reserve Bank.