

# CLIENT'S TAX AND FINANCIAL UPDATE

A Bimonthly Tax, Business, and Financial Planning Newsletter for our Clients and Friends

## HOW BANKS USE FINANCIAL RATIOS TO MEASURE YOUR PERFORMANCE

**W**hen 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.

*(continued page 4)*

## Tax Points

- **Loophole: Kids less than 14, the kiddie tax.** Transfer assets to your kids. The first \$1,600 of the investment income earned by your child under the age of 14 is taxed at the child's tax rate - not yours. The total federal tax on \$1,600 of your child's investment income is \$80.
- **Set up a Keogh plan before the end of the year.** To be eligible for a Keogh deduction on your 2005 income tax return, the plan must be prepared by December 31, 2005. Once the plan is prepared,

*(continued page 2)*

### INSIDE THIS ISSUE...

- How banks use financial ratios to measure your performance ..... 1
- Tax points ..... 1
- Personal money management: Hidden dangers in home equity loans ..... 2
- Better marketing:
  - Disciplined direct marketing
  - Conduct your own focus group ..... 2
- Reduce your income tax with an installment sale ..... 3
- Eliminate slow sellers for higher profits ..... 4

## TAX POINTS (from page 1)

you have until April 15, 2006 to pay your contribution for 2005. The maximum limit on Keogh contributions is \$42,000. **Loophole:** You can extend the due date for payment by filing an extension to your tax return.

- **Donate appreciated securities to charity.** The benefit is two-fold. No tax is owed on any capital gain that you would have from the sale of the securities. In addition, you get a deduction for the full fair market value of the securities on the date you make the gift.
- **Combine miscellaneous itemized deductions in the same year.** Only miscellaneous itemized deductions that exceed 2% of your adjusted gross income (AGI) is deductible. Consequently, most people find that their miscellaneous itemized deductions are not deductible. **Loophole:** By paying two years of expenses in the same year, you can often get over this 2% of AGI limit.
- **Loophole: Write off new business equipment.** The government allows you to expense, within limits, up to \$105,000 of equipment purchased each year. **Strategy:** If you need additional equipment, purchase it before the end of the year, not after, to claim this write-off.



# PERSONAL MONEY MANAGEMENT

## Hidden dangers in home equity loans

Home equity loans may not be as attractive as they seem. In the long run, they can sometimes be more costly than conventional types of loans. Contributors to high home equity loan costs: exces-

sive closing costs, variable interest rates without protective caps, high "point" charges, long payback periods, and large lump sum balloon payments at the end of the payback period. **Suggestion:** compare total costs between home equity loans and conventional loans before you borrow.



# BETTER MARKETING

## Disciplined direct marketing.

Many businesses are finding that direct marketing offers a productive alternative to other channels of distribution. Many of the guidelines for direct marketing are the same as those for any other successful sales effort, but there's one cardinal rule the direct marketer shouldn't ignore: *Develop one winning product at a time and focus on it.* The best direct marketing doesn't confuse the prospect with various alternatives. It spotlights one product and concentrates on its benefit to the customer.

Don't restrict your direct marketing efforts to gaining new customers. In fact, the customers who have already bought your product are your best bet for direct marketing. You can go back to them again and again. And when you choose the focus for your initial direct marketing effort, you should be thinking about a followup - additional products that will appeal to those who have already responded to your first offer.

In short, it's OK to promote a group of related products, but sell them one at a time.

## Conduct your own focus group.

Market researchers know that one of the best ways to get actionable marketing information is through a focus group - a forum in which a professional researcher poses questions to a group of potential buyers, distributors, or consumers. The questions asked in a focus group are usually different from those asked in a survey, where "yes/no" or multiple-choice answers are the norm. In focus groups the questions are open-ended. The person conducting the research doesn't look for specific responses, but asks for general opinions.

You don't need a costly formal focus group facility to do this kind of research. There's no reason, for instance, why you can't gather a group of your customers over lunch or late afternoon wine and cheese. In this informal setting you can invite, for example, suggestions about improvements or get reactions to ideas for new products. Your customers will probably be flattered that you've asked their opinion and you'll get a perspective on your business that may surprise you.

## TAX PLANNING

# REDUCE YOUR INCOME TAX WITH AN INSTALLMENT SALE

If you're thinking about selling real personal property at a substantial profit, you should consider an installment sale. An installment sale lets you report your capital gains over a number of years and can often result in sizeable tax savings.

Take Fred Butler, for example. Fred owns Greener Pastures, a thriving landscaping business. Greener Pastures was born when Fred entered State College and spent his summer vacations mowing lawns to help pay for his tuition. Fred quickly built a reputation for reliability and soon hired several fellow students to keep up with the demand for his services. By the time he finished his education, Fred had cultivated a growing business.

Now Fred wasn't the type to let the grass grow under his feet. So when one of his customers told him that he was thinking of selling a piece of land that Fred had maintained for some time, Fred plowed \$120,000 of his hard-earned profits into what he hoped would be a profitable investment.

Fred was right. Several years passed, and when land values blossomed, Fred decided to sell the property. It didn't take

long to dig up a buyer and when the property was sold for \$200,000, Fred made a handsome profit of \$80,000.

Unfortunately, Fred didn't realize that he had a silent partner who would reap a good portion of Fred's harvest. When Fred filed his 2004 federal income tax return, he discovered that, based on his \$75,000 salary from Greener Pastures, 2004 joint return tax rates, personal exemptions of \$6,200, and ignoring all other deductions, his federal income taxes totaled \$20,256.

### A BETTER SOLUTION

Fred had a green thumb for the landscaping business, but he paid a costly price for not knowing about the advantages of an installment sale. An installment sale would have allowed Fred to use the installment method of reporting his gain. Using that method, Fred's taxes on the gain would have been deferred over a number of years and his current taxes would have been sharply reduced.

Under the installment sale method of reporting, the gross profit on the sale

(when at least one payment is to be received after the year in which the sale is made) is prorated over the years in which payments are received rather than taxed in the year of the sale.

The taxable gain from an installment sale is determined by multiplying the installment sale receipts in the taxable year by the gross profit ratio for the sale. Because the gain is spread over a number of years, the installment method will usually result in a lower total income tax. (Special rules apply to dealers and to property used for business or owned for income).

Here's what this would mean to Fred Butler. If he had made an installment sale over four years and received payments of \$50,000 each year, he would report only \$20,000 of income from the sale on his 2004 income tax return as shown here:

Gross profit (\$200,000 selling price less \$120,000 cost) .....	\$80,000
Gross profit ratio (\$80,000 gross profit divided by \$200,000 selling price) ...	40%
Taxable income (40% of \$50,000 per year) .....	\$20,000

For Fred, this would produce significant tax savings. If he had sold his land and received payments of \$50,000 a year for four years, he would report only \$20,000 in gain on his 2004 tax return instead of \$80,000. This would reduce his federal income tax from \$20,256 to \$11,256.

Deciding when and how to make an installment sale requires training and experience. Your accountant will be glad to give you the professional advice that's right for your situation.

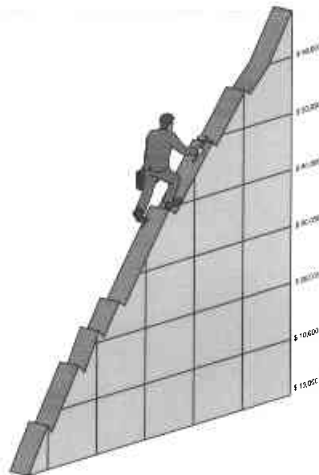


# YOU AND YOUR MONEY

## FINANCIAL RATIOS *(from page 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 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 net sales by average inventory in a given time period, you can determine how many times your inventory has turned over. Because it is based on financial information, this turnover does not represent actual physical inventory turnover, but if it is high, it is usually an indication that your inventory turnover is good.
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 under-capitalized. 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 intangible 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.



## ELIMINATE SLOW SELLERS FOR HIGHER PROFITS

In most multi-product businesses, 80% of a company's sales volume comes from 20% of its product line. Because slow-selling items usually account for a very small percentage of sales, there's good reason to believe that they can have a negative impact on profitability. When the true costs of slow-moving items are considered, it's quite possible that some of them might actually be losing money for the company.

The real costs of slow-selling items include a variety of factors that are often overlooked by management. Because of the small quantities involved, slow-sellers can mean higher unit manufacturing or purchasing costs, as well as interest charges on the inventory investment and excessive storage costs such as rent and insurance. In addition, the inventory of slow-selling products can tie up cash which could be used more productively elsewhere.

The reason usually given for not dropping slow-selling items is that a company must have a "complete" product line. This assumption is frequently incorrect because customers don't turn to competition unless they are generally dissatisfied. Furthermore, customers will usually accept replacement products for slow-moving items that are no longer available.

If a company has a slow-selling product problem - particularly with items that show a continuing decline in sales - careful consideration should be given to improving profitability by phasing them out of the line when inventories are depleted.