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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

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Loophole: Allocation of partnership profits or losses among partners can easily be changed each year. In a partnership, individual partners report on their personal tax returns any profits and losses in proportion to their ownership stakes. However, once you set up the initial percentages, you can change them by modifying the partnership agreement.

Loophole: Sell the stock of a C corporation, not its individual assets. *Why:* A stock sale generates capital gains taxed at a top rate of 15%. In contrast, a sale of assets generates a combination of ordinary income – taxed at a top tax rate of 35% and “recapture” of previous tax breaks. Furthermore, asset sales are taxed twice—first at the corporate level and then again when the sales proceeds are distributed to corporate shareholders.

Loophole: Disabled people can deduct medical expenses related to their disabilities to the extent that they exceed 7.5% of adjusted gross income (AGI). *Examples:* Wheelchairs, hearing aids, guide dogs, artificial limbs.

Rent before selling. If, when you wish to sell your home, the market is weak, you can lease it out for income until sales prices rise. The home will still qualify for exclusion of gain as long as it meets the two-of-five-prior-years test for ownership and residence. This tax break allows you to rent your home for up to three years during this five year period and still take advantage of the exclusion of gain. An individual may exclude from income up to \$250,000 of gain (\$500,000 on a joint return in most situations) realized on the sale or exchange of a principal residence.

How to Compare Taxable Yields with Tax-Exempt Yields

Here's a simple chart to help you determine whether you should put your money in a taxable or a non-taxable investment:

TAX-EXEMPT YIELD	TAXABLE EQUIVALENT		
	AT 15% TAX RATE	AT 28% TAX RATE	AT 35% TAX RATE
3%	3.53%	4.17%	4.62%
4%	4.71%	5.56%	6.15%
5%	5.88%	6.94%	7.69%
6%	7.06%	8.33%	9.23%

Tax Credits for Child Care Costs

The IRS has included requirements to what you must do to get a tax credit for child care costs. To take the child care credit, you must supply the Tax Identification Number (TIN) of the child care provider on the IRS tax Form 2441.

Whether the child care provider is a day care center or an individual, the law requires that the provider must supply you with a TIN. In addition to a TIN, you must also include the provider's name and address on your return.

You can take the tax credit only if you pay for child care expenses in order to maintain gainful employment. The tax credit is equal to 35% of your employment related child care expenses for taxpayers with an adjusted gross income (AGI) \$15,000 or less. However, the credit is reduced by one percent for each \$2,000 of income, or fraction thereof, for taxpayers who have adjusted gross income of over \$15,000. If your adjusted gross income is more than \$43,000, you are allowed a maximum tax credit of 20% of your employment

related expenses. For one qualifying individual, the maximum amount of employment related expenses to which the credit can be applied is \$3,000. For two or more qualifying individuals the maximum amount is \$6,000.

Child care tax credits can produce significant tax savings, but be sure your child care provider gives you a TIN number so you can file properly.



How to Turn a Taxable Loss into a Tax Refund

Even a business with a steady record of profitable operations can have an occasional bad year. But if you own a company that suddenly shows a net operating loss, you may be able to turn that loss into a cash refund of taxes you paid in past years.

Sam White is a good example. Sam owns White Wind Boats, Inc., a well-established and successful maker of luxury power boats. For thirty years, Sam has carefully navigated a course that brought a steady stream of profits to White Wind Boats.

Sam's business philosophy was simple; produce the best power boat in the industry and people will buy it. The strategy worked and White Wind Boats became the standard of quality to serious sport fishermen and weekend boatmen alike. Bolstered by a good economy, Sam's business cruised along to record growth until 2011 when, without warning, the tide turned.

Sales had never been better, but like all power boat makers, White Wind Boats purchased its marine engines from an engine manufacturer. When Sam's engine supplier suddenly pulled up anchor, White Wind Boats found itself in very rough waters.

Sam immediately found a new source for his marine engines, but it would be months before the supplier could deliver. In the meantime, unfilled orders for White Wind Boats continued to pile up. Sam kept his production line running and it wasn't long before he was looking at a sizeable number of completed boats – completed, of course, except for the engines.

Finally, only days after White Wind Boats' year end, the engines arrived, but not before dozens of disappointed buyers had cancelled their orders.

It will be a costly year for White Wind Boats and when the results are in, the company will show a taxable loss of \$110,000 for the year ending December 31, 2011 – the first year in the company's history that it will not show a profit. Obviously, the company will pay no income taxes, and Sam will settle for the hope of smoother waters in the years to come.

A BETTER SOLUTION

Sam White will feel a lot better about the sudden storm that hit his business if he uses the tax laws as productively as he builds his boats.

because in addition to paying no income taxes for 2011, White Wind Boats, Inc., will receive a cash refund for a portion of the taxes it paid dating back to its 2009 tax year.

Here's what a two-year carryback of White Wind Boats' 2011 taxable loss of \$110,000 will mean to Sam White, assuming the taxable income is as reported here.

It's apparent from the table below that a two-year carryback of Sam's 2011 taxable loss will mean a total tax refund of \$18,500, a major contribution to charting a future course of success for White Wind Boats.

The proper treatment of a taxable loss can have a substantial impact on your taxes, and you should consult with your accountant to determine how carryback and carryforward tax laws can best be applied to your individual situation.



TWO-YEAR CARRYBACK	TAX YEAR ENDING 12/31/09	TAX YEAR ENDING 12/31/10
Taxable income as previously filed	\$70,000	\$50,000
Less allowable carryback of 2011 taxable loss	70,000	40,000
Adjusted taxable income after carryback	0	10,000
Taxes previously paid	12,500	7,500
Less adjusted taxes after 2011 loss carryback	0	1,500
Tax refund due White Wind Boats, Inc.	\$12,500	\$ 6,000

Taxpayers who experience a taxable loss have two options: One option is to first carryback the loss two years and then to carry it forward for twenty years. The other option is to forego the carryback option and carry the loss forward twenty years.

For Sam White, carrying back his 2011 taxable loss over the two prior tax years will produce dramatic results,



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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 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 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.

How to Measure Sales Staff Performance

Judging the performance of your sales personnel by looking only at gross sales figures can be misleading, since one or two large orders can distort the true picture. Even worse, gross sales dollars won't tell you when the cost of making sales is too high.

Here are five ways to help you pinpoint sales productivity:

1. **Average dollars per sale.** Simply divide total dollar sales by the number of orders.
2. **Dollar sales per salesperson.** Divide total dollar sales by the number of full-time sales personnel.
3. **Orders per salesperson.** Divide the total number of orders by the number of full-time sales personnel.
4. **Sales per hour.** Divide the total dollar sales by the total hours worked by all sales personnel.
5. **Percent of selling costs to sales.** Divide the total salesperson salaries and commissions by total dollar sales.

You can apply these measurements to individual salespeople or to departments. You can use them to compare performance between individuals or departments, or to compare current activities to previous performance. Used wisely, this information will help you judge sales productivity and profitability more accurately.