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Financial Health 101 – Understanding your Balance Sheet

Whether or not you own a small business, every one should periodically review a balance sheet in order to asses their financial health. I prepare financial statements for small businesses on a monthly or quarterly basis, and occasionally prepare personal financial statements for individuals. Most people tend to focus on the P&L, or Profit & Loss Statement which is fairly easy to understand (income minus expenses). So what's on a balance sheet? It starts with assets. Assets include those which are liquid such as cash (money in checking, or savings accounts), investments (stocks, bonds, and other long-term savings), and accounts receivable or notes receivable (money owed to you). Current assets are followed by less liquid assets such as inventory on hand, investment properties, fixed assets (buildings, computers, furniture, tools, and equipment), and intangible assets (start-up costs, goodwill, and other amortizable items). Total assets are followed by debt. Debt can be classified as either short-term (due in 1 year or less) or long-term. The balance sheet concludes with Equity (a.k.a. Net Worth) which is the sum of assets, minus debt. I have included a sample balance sheet below.

Assets	
Current Assets	
Checking Account	1,000.00
Savings Account	5,000.00
Investment Account	5,000.00
Total Current Assets	11,000.00
Other Assets	
Investment Property	200,000.00
Fixed Assets	
Computer Equipment	4,000.00
Office Furniture	3,000.00
Telephones	1,000.00
Rental Property	120,000.00
Vehicles	35,000.00
Less: Accumulated Depreciation	-20,000.00
Total Assets	**354,000.00**
Liabilities & Equity	
Liabilities	
Current Liabilities	
Payroll Taxes Payable	3,000.00
Total Current Liabilities	3,000.00
Long-Term Liabilities	
Credit Cards Payable	20,000.00
Mortgages Payable	295,000.00
Vehicle Loan Payable	25,000.00
Equity	
Common Stock	500.00
Additional Paid in Capital	500.00
Retained Earnings	5,000.00
Net Income	5,000.00
Total Liabilities & Equity	**354,000.00**

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You will note that "Total Assets" equals "Total Liabilities & Equity". This is always the case. That's why it's called a balance sheet, because it must always balance. Now let's examine just a couple of financial ratios to get an idea on the health of this particular entity. We will examine the current ratio, debt to equity ratio, and working capital. Keep in mind that this is just a simple example of how financial statements may be used, and that in real life many other factors need to be considered in determining one's financial health. This example is that of a *cash basis* business. *There may be other factors to consider such as the market value of real property and investment assets, and the amount of any accounts receivable.*

Current Ratio – The Current Ratio calculates how many dollars in assets are available to pay short-term debts that are due during the same year. This is calculated by dividing current assets by current liabilities. In this case $11,000/3,000 equals 3.66. An acceptable current ratio varies by industry but generally if the number is below 1 there is cause for concern. A current ratio of less than 1 would indicate that there is not enough cash on hand to cover current bills. A ratio of 1 would indicate the entity has just enough cash to cover current debts. Generally a ratio of 1.5 or 2 is a sign of good financial health. A current ratio of 3 or 4, on the other hand, may be a sign that there is too much cash on hand, cash which could be invested more productively in outside investments, or perhaps used to pay down a portion of the long-term debt. In this example, excess cash has been moved to savings and investment accounts where there is a chance for growth. Idle cash left in non-interest bearing accounts is generally subject to inflation risk, since the price of goods and services generally goes up about 3% every year.

Debt to Equity Ratio – The Debt to Equity Ratio measures how much money an entity should safely be able to borrow over long periods of time. It does this by dividing Total Debt (short-term and long-term) by the amount of Equity. Generally, a Debt to Equity ratio of 40% or more should be looked at carefully to make sure there are no liquidity problems. The percentage obtained refers to the percentage of the entity that is indebted (or leveraged). In the example above, the debt to equity ratio is 3,118% (343,000/11,000). This means that this company (or individuals) assets are leveraged by 3,118%. There is plenty of cause for concern in this case, because the creditors virtually own the business. However, an important factor to consider is whether the entity can earn a higher rate of return than the interest rate at which it borrows. If so, then it is profitable to borrow. For example, if the entity in question can earn 15% on its investments and borrows funds at 8%, it will make a 7% return on borrowed money. Further analysis needs to be done to determine what percentage of return can be expected on the *rental and investment properties* owned by this entity, as compared to the interest rate charged on its debt. Another factor to consider would be whether long term debt is increasing or declining. It is a positive if long term debt is declining each year.

Capitalization Rate – Rental Real Estate Investors should consider their capitalization rate (Cap Rate). The Cap Rate is the un-leveraged return expected on a property, expressed as the anticipated cash flow return (before depreciation) as a percentage of the purchase price (Cap Rate = Cash Flow/Cost of Property). A low cap rate could spell trouble.

Working Capital – The number one reason most people check the balance sheet is to determine the amount of working capital. Working Capital tells you what would be left if the entity raised all of its short term resources and used them to pay off its short term debt. The more working capital, the less financial strain it will experience. The formula for working capital is simply: [Current Assets – Current Liabilities = Working Capital]. In our example, the amount of working capital is $8,000 (11,000 – 3,000). Businesses that raise cash daily (such as a grocery store) need very little working capital. On the other hand, businesses that sell on credit can't raise cash as quickly and require more working capital to get through any unforeseen difficulties. Many individuals live from paycheck to paycheck and if they were to suddenly lose their job would be in trouble. The suggestion to have an emergency fund of 3 to 6 months worth of living expenses is a form of working capital for a household.

Tracking Mileage

Anyone who uses a vehicle in connection with a business or un-reimbursed job capacity needs to track mileage. Every year at tax time three questions will be asked. How many total miles were placed on the vehicle for the

year? How many business miles? Finally, how many commuting miles? Mileage for commuting back in forth to a job or regular place of business is not deductible. Personal mileage is not deductible. Only the amount of business mileage is deductible. One other question asked on your tax return is "do you have another vehicle available for personal use?" If you are claiming 100% business use of a particular vehicle, this would only make sense if another vehicle is available for personal use.

Note: The Standard mileage rate for 2007 is 48.5 cents per mile.

So how do you track the total mileage placed on your vehicle for the year? One way would be to keep an annual folder that contains all repairs and maintenance receipts including your annual emissions inspection test. For example, what I do is compare the mileage on my annual emissions inspection reports to obtain total annual mileage. One could also obtain mileage from oil change or maintenance receipts and subtract or multiply to obtain a fair estimate. Of course, the easiest way is to write down your odometer reading at the beginning and end of each year, and record that in a mileage log. You can purchase a mileage log book at an office store for under $2.00.

The next issue is how to track business mileage. If your vehicle is used for both business and personal use, it would make sense to keep a log of business mileage. Every time your vehicle is used for a business meeting, or for a visit to a customer location, you will record the date, location or customer, and the number of miles for the round trip. This can either be done in a mileage log book, day planner, calendar, or spreadsheet. At the end of the year you can add up the total business miles.

If your vehicle is used primarily for business, it would be easier to track the smaller amounts of personal mileage. In this case you would record any personal trips to the grocery store, children's school, vacations, and such.

If you are ever audited for vehicle expenses, the IRS will ask to see a copy of your mileage log. If you can't produce a log, or otherwise come up with a reasonable estimate, the IRS may disallow your expenses. This can be very costly, especially if you have taken write-offs for the full purchase price of the vehicle in prior years. In short, whether you use the standard mileage rate, or the actual expense method (including depreciation), *you* are required to track and report your total, business, and commuting miles on your income tax forms. Finally, note that the IRS has been aggressively auditing business and personal tax returns and verifying vehicle expenses including mileage.

Tax Compliance

As an Enrolled Agent, I am licensed and governed under U.S. Treasury Circular 230. Enrolled Agents, CPA's, and Attorneys who violate Circular 230 may be subject to disbarment, suspension, or censure. The American Jobs Act of 2004 has recently authorized the IRS to impose monetary penalties in addition to, or in lieu of, disbarment, suspension or censure. Please keep this in mind when you are providing me with documentation to support your business or personal tax or accounting work. I will not knowingly mislead the government on the behalf of a client, since doing so could lead to my own demise. "No client is worth losing the right to practice." If I can make a reasonable estimate based on what you have provided I will, but if not, then I would rather disengage than just throw something together so I can make a dollar.

LLCs and "Check-the-Box" Regulations

Sixth Circuit Court of Appeals – A taxpayer who did not elect to treat several limited liability companies (LLCs) he owned as corporations under the check-the-box regulations was determined to be personally liable for unpaid federal employment taxes. The court further found that the IRS did not have to recognize the separate existence of LLCs as a matter of state law. According to the court, the federal government has long disregarded state classifications of businesses for some federal tax purposes. Had the taxpayer elected to have the LLCs treated as Corporations for tax purposes, he could have separated himself personally from the debts of the LLCs. However, for employment tax purposes an officer of a Corporation can still be held personally liable for unpaid employment taxes under the Federal Trust Fund Recovery rules. You should always make sure that your business is properly structured. Starting a business without professional tax advice is not recommended.

Proposed Regulations – "Open Account Debt" and S-Corps

The IRS has recently issued proposed regulations that would limit the use by S Corporations of open account debt to $10,000. What is Open Account Debt? To fund the activities of their businesses, S corporation shareholders often make informal loans to the company that do not involve formal contracts for repayment. This type of debt is referred to by the Code Sec. 1367 regulations as "open account debt." All such advances to and repayments from the company are treated as one single debt. The proposal could affect the shareholders basis in the company. As you may know K-1 distributions in excess of basis are treated as Capital Gains, and losses in excess of basis are not deductible in the current year. One way to avoid the trap is to create a promissory note whenever you loan money to your business. The business should make repayments to the shareholder with interest on a regular payment schedule. The interest expense is deductible by the company, and taxable income to the shareholder. Under no circumstances should the company repay debts directly to the creditors of the shareholder.

For example, if a shareholder takes out a home equity line on his or her residence and loans the proceeds to the business and the business makes payments directly to the mortgage company, several problems are created. First, the shareholder may not be allowed to deduct the interest, because the shareholder did not make the payments. Second, the business may not be able to deduct the interest because the debt is not in the company's name. Third, this would be considered "open account debt" which may be limited to $10,000. The bottom line is if you make loans to your company do it with a formal promissory note, have the company pay you back, and make repayments to your creditors out of your personal checking account.

Capital Gains Tax vs. 1031 Exchange

A client recently asked whether they could do a Section 1031 exchange on a property they are in process of selling. A Section 1031 exchange is where you can sell property and defer tax on the gain as long as the gain is rolled over into another like-kind property. All real estate is considered like-kind property; so for example, you can exchange land for residential property, or one property for two or more. I explained the procedure for doing so which is more involved than I want to go into right now. I also posed the question, "do you really want to defer the gain into the future"? My reasoning is that right now the maximum capital gains tax is 15% for property held more than one year. The rate is 5% for individuals in the 10-15% tax bracket. Beginning in 2008 the 5% rate will be reduced to 0%. Both the 15% and 0% capital gains rates will expire at the end of 2010. Under present law, the capital gains rates will return to 20% for individuals in the 25% or higher tax bracket, and 10% for individuals in the 10-15% bracket. With a 1031 exchange, the danger would be that you defer your gain into the future when the tax may actually be higher, as may your gain. We know what the tax rates are today, but there is always the possibility that Congress, or a new administration could radically change tax rates for the worse. With tax planning, there is no cookie cutter formula. Planning is done on an individual basis based on the goals, and current or future financial prospects of each client. What works for one person may not work for another. While it's obvious that the best scenario would be to sell between 2008 and 2010, and to limit your tax bracket to 15%, the big question is how to do that in a way that is both legal and practical. The bottom line is that the present capital gains tax rates, and those coming in 2008 may be 'as good as it gets'.

Note: Since the actual rate you pay is averaged based on the amount of your income above or below the bracket, most people will pay somewhere between 5 to 15% today, and between 0 to 15% in 2008 through 2010.

Pending Due Dates

July 16, 2007 – 2006 Trust & Estate Tax Return Ext. Deadline
July 31, 2007 – 2nd Quarter Payroll Tax Return Deadline (this is not the deadline for submitting your data)
August 15, 2007 – 2006 Non-Profit Returns Ext. Deadline
September 15, 2007 – 2006 Corporation & S-Corporation Returns Ext. Deadline (last day for 2006 SEP contributions)
October 15, 2007 – 2006 Individual and Partnership Returns Ext. Deadline

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