

# Strothman & Company PSC

## Financial News & Views

1600 Waterfront Plaza • 325 W. Main Street • Louisville, Kentucky • 502.585.1600 • <http://www.strothman.com/>

### May 2010

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## General Business News

### Managing your business by the numbers

Just about any accountant you talk to will stress the importance of timely financial information in managing your business. Your balance sheet and income statement can tell you a great deal about the health of your company – its past and perhaps even its future. Comparing operating results to prior periods is invaluable, as is comparison with other companies in your industry. This month's article will focus on operating results and industry data for you to consider.

#### Significant operating ratios

**Current Ratio** – this is essentially a measure of your company's ability to pay bills as they come due. It is calculated by dividing your total current assets (cash, accounts receivable, inventories, short-term investments and prepaid expenses) by current liabilities (accounts payable, expense accruals, current portion of long-term debt). While there is no hard and fast rule as to what your current ratio should be, one of less than 1:1 is not desirable. The higher the ratio, the better off you are.

**Quick Ratio** – this is also a measure of your company's ability to pay bills as they come due. It further refines the quick ratio by eliminating all but the most liquid of assets. In the calculation, prepaid assets and inventories are eliminated from current assets. In effect, it provides a measure of your company's ability to pay bills immediately.

**Days Sales in Receivables** – this tells you how quickly you are collecting amounts due your company. This ratio divides the total receivables by average daily sales. Here is an example: you had receivables of \$36,500 and annual sales were \$365,000, so the calculation would be  $[36,500 / (365,000/365)]$  or 36.5. This number can fluctuate widely by industry.

**Days Cost of Sales in Inventory** – this tells you how well you are managing inventory. The calculation is similar to days sales in

receivables, except the numerator is inventory and the denominator is average cost of sales. This ratio can also fluctuate widely from industry to industry. Inventory turnover is very closely related. For example, assume cost of sales is \$3.65 million and inventory is \$365,000. This means that days cost of sales in inventory is 36.5. Inventory turnover is \$3.65 million/\$365,000 or 10 times. You can reach the same ratio by dividing 365 days by the days cost of sales in inventory of 36.5.

Days Purchases in Accounts Payable – this tells how current your payables are. Calculated by dividing accounts payable by average daily purchases, this ratio, when compared to normal payment terms, will tell you whether you are paying your bills currently or not.

Debt to Equity – this helps you determine how well your company manages debt. The calculation is based on total debt, including normal trade payables, divided by your equity in the company. This ratio helps you determine how much of the company's assets are financed internally and externally. This ratio can heavily influence company value.

Gross Profit on Sales – this tells you how much of each sales dollar is available to cover expenses other than the cost of acquiring or producing the item sold. This ratio is highly dependent on a company's industry. The calculation basically subtracts cost of sales from sales. This number is then divided by sales.

Net Income to Sales – this tells you how well you manage your costs and expenses. Just like gross profit, this ratio can vary widely by industry.

## Data sources

Your first and most important data source for operating statistics is your own financial statements. Prior months' or years' ratios compared to current results will help you understand if your operating philosophy is working. This comparison will allow you to see if the business is headed in the right direction or whether you need to change operations to achieve the results you want.

Secondly, many trade groups maintain operation data. Whenever possible, join appropriate groups and leverage their knowledge on how to run your business. Statistics maintained by professional or trade organizations are likely to be the most accurate. Be sure to obtain information about companies similar to yours in size and operations.

Outside data firms such as Robert Morris Associates and BizStats provide industry ratios – usually for a price. They provide high-quality information for a generally reasonable cost. You also might be able to get some information from your banker.

## Conclusion

Effective review of your financial statements and comparison to your peers can be invaluable in managing your business. Many research agencies provide high-quality data at reasonable prices to help you compare your operations to others, but you need to make certain that you are comparing apples to apples. Give us a call and let us help you design an appropriate financial monitoring system for your business.

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## Tax News

Is a checkbook enough?

Documenting losses on a part-time business

What do Tupperware, Shaklee and Mary Kay have in common? Their products aren't similar, but they all do business the same

way and depend on the average consumer to sell their products. Based on their bottom lines, these companies and others like them have been very successful. Add to these lines of business the doctor who also raises cattle or the professional who makes jewelry in his or her spare time and the similarities become harder to find.

So what might these dissimilar businesses have in common? At tax time, their proprietors need to prove they are...well.... businesses. In some cases, the stakes can be high.

Here's an example: take the professional who earns a salary of \$500,000 but spends \$100,000 on a cattle operation. He or she might have sold a few head of cattle this year but more typically took a loss on the operations – and the IRS does not like to see this on a taxpayer's return.

Then there's the carpenter who works for a construction company all day and goes home to knock out a few objects d'art before bedtime. Some might say this is a hobby, but in his mind he's trying to get a second career going and hoping someday to become another Picasso.

Finally, there are those who get into sales of Tupperware and other products because they like the product and want to earn the starter kit. That might be all they want to do, but they are still selling a product and turning a profit, albeit a small one.

What's wrong with taking a deduction for the losses these self-starters might incur in the pursuit of their dreams? A lot of people might answer nothing. Unfortunately, the Internal Revenue Code is not necessarily formulated that way. If you're in a similar situation, how can you protect yourself in the event of an audit?

## The Rules

Internal Revenue Code Section 183 limits the amount that can be deducted when you are not engaged in an activity for profit. Basically, the deductions are limited to the gross income from the activity. To illustrate this, let's say you raise cattle in your spare time and you incur \$100,000 in expenses, including the cost of the cattle in the activity. Assuming your sales for the year total \$50,000, you show a loss of \$50,000. If the IRS can show you did not intend to turn a profit on the cattle operation, then your deductions against income are limited to \$50,000 – not very favorable to your tax bill. If you can prove the operation is meant to turn a profit, you might be able to deduct the full \$100,000 and offset other income by the net \$50,000 loss. How will you do that?

You can argue until the cows come home that you planned to make money, but the IRS will look use a nine-factor test to determine whether the business is engaged in for profit. Here is what you will do.

First, you will operate your cattle operation in a businesslike manner. That means keeping adequate records and separating your personal funds from the business funds. It's not enough to rely on cancelled checks. In one case, the Tax Court determined that a horse breeder did keep adequate records because he meticulously recorded the horses' pedigrees and all of the pertinent expenses and income in a farm record book. On the other hand, the only financial information supporting his deductions were cancelled checks, so the court determined the operation was not run in a businesslike manner.

Second, you will show that you have the expertise to operate a cattle farm profitably. If you don't have the expertise, find someone who does. In one case, a taxpayer was born and raised on a farm. In denying his loss deduction, the court said the taxpayer did not know how to make a profit from his current farm undertakings and, while he did seek advice about farm concerns, he did not seek advice on how to make a profit at farming.

Third, you will show that you spend substantial time and effort on the cattle operations and that your efforts were designed to enable your operations to make a profit. It is not necessary to spend 40 hours a week on the operation, but you will need to show involvement in the business. Hiring a full-time ranch supervisor to act in your stead would fill the bill. This is very much what the IRS likes to call a facts and circumstances situation.

The term profit does not necessarily mean that you make money on the activity itself. If, for example, you reasonably expect the investments made in the cattle operation to enhance the value of your land, this could be enough to prove a profit motive. You will need to show that you expect the gain from appreciation in the asset's value to exceed the annual losses, thereby realizing a net gain over the life of your project.

Your past track record in showing a profit from other activities, whether similar or dissimilar, will also be a factor in determining if you can reasonably be expected to profit from your present operations. In one case, the IRS disallowed the expenses a lawyer incurred in a failed attempt to facilitate the sale of artwork. The court looked to past transactions where the lawyer served in similar capacities and did, indeed, realize a profit. The irony is that those successful transactions were the cause of the IRS investigation in the first place. The court ruled the taxpayer was engaged in the activity with a profit motive.

Your intent to create a profit from your cattle operation can also be shown by the business' history of profit and loss. In the early years of a start-up venture, losses are to be expected. If your cattle operation turns a profit in three of the last five consecutive years – ending with the tax year in question – the business is considered to be operated with a profit motive (unless otherwise proven by the IRS).

The amount of an occasional profit in relation to losses is also indicative of a profit motive. For example, if you typically incur small losses but occasionally earn significant profits on the sale of cattle to offset those losses, this could indicate that you are engaged in an activity designed to turn a profit.

Your financial status also might be considered relevant to your motives for entering into the cattle farming business. Generally, the less you have, the easier it is to prove you are running a business to produce income for you and your family's support.

Finally, is there an element of personal or recreational enjoyment involved? Not the incidental kind that comes from a job well done, but real enjoyment? For example, are you taking your personal boat out for deep sea fishing excursions? Such a situation arose recently and the court found in favor of the IRS.

## The Lessons

It is not uncommon for taxpayers to think their business must turn a profit three out of five years to escape hobby loss treatment. The truth is, however, that individual facts and circumstances must be examined to determine if you are likely to be challenged on deducting your business losses. Keeping a checkbook is not enough to stave off an aggressive IRS agent. Give us a call if you have part-time activities that produce losses and let's find a way to document your actions to prove you are engaged in profit-driven behavior.

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## Tip of the Month

### Tip: Business plans work

Sometimes in these days of twittering and instant messaging, it is tempting to question whether business plans are obsolete. The answer is a resounding no. Without a business plan, your ideas, financial planning and basic strategy almost certainly will be vague in parts – and any business pitch you make will lack the strong foundation needed to attract serious attention from prospective investors, business partners and others whose support is required.

Let's consider some planning fundamentals and determine what a plan will do for you and for your business.

## A road map

A good business plan is your road map. It establishes your starting point, the things you must do before hitting the highway, the reason for the trip, the steps and the best direction you need to take, an estimated time of arrival and so on. In this way, a basic plan will generally require that you have researched the following prior to starting out:

- A well-defined product or service
- An estimate of the size and purchasing power of the target audience
- Assessment of competitors or issues that impact purchasing decisions
- Unique selling points or competitive edge your product/service offers
- Projected growth rates
- Sales forecast
- Marketing tools
- Timeline
- Calendar showing time frame for measurement and assessment of plan's progress against stated goals and objectives
- Budget projections (start-up costs, cash flow estimates)
- Skills and expertise of the management team

A good plan is articulate, concise and to-the-point. Developing the plan is a means to an end, not a project that requires months of drafting, revising and editing. However, it is vital that a business plan shows you know your targeted market well, that your financial planning is good and that your strategy includes measurable goals.

## Dos and Don'ts

- Recognize that the business plan is the basis for your future presentations and pitches. Write it based on the research that shaped your strategy. Without a business plan, you will be stumped for an answer if your audience challenges any budget estimates or sales and marketing assumptions.
- Keep it simple and as short as possible. Avoid ambiguity, industry buzzwords or any kind of jargon or unexplained acronyms. If you are uncertain about something, do more research. Above all, don't try to impress people with complicated language. Your audience will pick up on any lack of clarity or wild guesses immediately.
- Anticipate change and revisions. Review the plan regularly. The basic components might need revision along the way, but they will still be an integral part of the overall plan. Short-term goals and projections might have to be revised and management might need to change intermediate priorities in order to meet the long-term objective.
- Be skeptical if someone tells you to bypass the business plan and go straight for the business pitch. Even if the people you are pitching to do not seem interested in your business plan, experienced analysts back at their office will take a hard look at it.

Bottom line: though the pace of business has accelerated and change is constant, entrepreneurs still need to develop a basic business plan before charging ahead. The effort and dollars required to draft a plan are a good investment and a major factor in business success.

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## Financial News

### Stock Market: Amended expectations

There is much to be happy about these days: the market is up almost 80 percent from its lows of 12 months ago, corporate earnings are beating estimates and business spending is on an upswing. The Fed's announcement at the end of April that it did not plan to raise interest rates anytime soon was also likely to please investors. Despite all this, some experts remain poised and ready for the current positive market performance to take a nose dive. Rather than try to untangle the various viewpoints – you'll note that both bulls and bears often use the same data to support opposing positions – it is worth remembering that all analysts are right at some point in time.

Without a doubt, analysis and market performance predictions are difficult, and the conventional wisdom of the past is no longer relevant to the new recovery. Few experienced investors expect to see a return to the fast economic growth we had for the majority of the last decade, and most hope for steady growth. They realize that the worst is over. The government acted to stabilize banks and major financial institutions, and the U.S. economy has bottomed out. It's what happens now that has analysts puzzled. Some fret over the possibility that individual investors will grow impatient with slow economic growth and become nervous when they don't see a dramatic rebound in the economy this year.

## Interest Rates

For these bears, the Fed's April announcement that it sees further signs of improvement in the U.S. economy – but not sufficient to raise interest rates – should be a relief. The continuance of cheap money in the U.S. should help get the economy back on track faster. Other countries have begun to raise interest rates, and many see this as detrimental to global economic recovery. Some investment experts applaud the Fed's decision to keep rates at current levels because higher rates would have created more damage to investors' confidence. The language the Fed used remained essentially the same: improvements were noted in increased capital expenditures but "high unemployment, modest income growth, lower housing wealth and tight credit" were also cited.

The stock market continues to have low trading volumes. Analysts attribute this to investors' skepticism and lack of confidence, as well as reduced inflows from mutual funds. You can look on this as positive – there is plenty of purchasing power in the wings to boost future volume and stock prices; or as a negative – demonstrating how severely the market decline has damaged investors' trust.

Finally, many pundits believe that although they remain unchanged, interest rates must rise before too long. They suggest revisiting your portfolio to get ready to shift gears when that time comes. Your portfolio picks might be influenced by predictions that:

- Dividend-paying, fixed-income investments and bonds will prove to be less attractive options for investors;
- Fears of inflation will diminish, which is bad news for hedges like commodities and gold;
- The dollar will gain strength. Foreign investment will increase as investors seek government bonds and other investment vehicles that are tied to the U.S. dollar. Financial experts are already announcing that more foreign capital is coming into the United States.

Future rate increases don't mean you should make substantive changes now. As always, all general observations are not intended to replace consultations with your professional tax advisor and your legal counsel.

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## Technology News

### Technology: The iPad...decisions, decisions, decisions

If you are as technologically dependent as most bosses and business owners today, you've been watching the launch of the

iPad and wondering whether to get one. Here are some thoughts to mull over if you are contemplating buying a tablet.

## What does it offer? Do you need one?

First of all, let's consider what the iPad is and what key features it offers.

- What is it? First of all, the iPad is hard to classify. It's not a computer and lacks some of the features and capabilities we usually expect from a computer. It will not replace your notebook, but it is more advanced than a smart phone or personal digital device. Individuals will need to look at key features to see if this new hybrid fits their current pattern of Internet usage, and if it is a good investment.
- Who is most likely to make good use of it? People who love e-reading and Internet-based entertainment. The iPad is perhaps most appealing to people who like to read books online, e-readers and those who browse the Web frequently, watch movies or play games on their current Internet-enabled device. Its larger screen, Wi-Fi capabilities and, in the case of the higher-end models, 3-G Internet connectivity are big pluses for many users. The battery is designed to last 10 hours even with lots of usage.
- What about costs for hardware and subscriptions? Models start at around \$500, but you'll need to pay around \$800 for 3G capability and 64GB of storage. Is that pricey for what the iPad provides? Perhaps. Subscription rates for 3G capability with an unlimited data plan that will provide almost constant access to the Internet go for a reasonable \$30 a month. Accessories are available (purchased separately). They include a docking capability that comes with an external keyboard.
- What are its limitations? The iPad doesn't offer a USB port, an optical disc drive, a keyboard (unless you purchase the keyboard accessory package) or a mouse.
- What about applications/software? Your software options are to be found in the iPhone App store. The iPad doesn't allow users to open multiple apps simultaneously, so if this is an important feature to you, it probably won't suit you. The iPad is compatible with the iPhone operating system but not the MAC operating system.

The iPad has competition. Rival tablets all retail for about the same as the iPad base model, and each one offers features that the iPad and the others don't have. Here are some of them:

- **JooJoo** is aimed at Web surfers and has shortcuts to Twitter and Facebook. It has a webcam and is designed to provide high-quality streaming HD video. Its battery life is about half that of the iPad.
- **Entourage Edge** runs on Google Android and has a camera and two screens, one for e-readers and one for Web use. Its batteries last 16 hours in e-reading mode and six hours for color use.

One other product, The Notion Ink Adam, is slated for launch in June. It will offer an HDMI port, a memory card slot and a camera.

Determining if the iPad is a useful addition to your technology tool kit is something that each of us has to decide for ourselves. There will always be early adopters who want to try new technology first, but there is a larger contingent that patiently waits for more feedback from the first users, and for prices to drop.

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Please plan to attend our Special Edition Seminar on Thursday, May 13<sup>th</sup> at Owl Creek Country Club to learn more about how the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act will affect you and your business.

Myron Hobbs of Insuramax, a long time client of Strothman & Company, will be presenting a summary of these new acts. Joe Johnston, Senior Manager of the Strothman & Company Tax Group, will be presenting the tax effects of this controversial

legislation.

2010 Seminar Series  
Thursday  
May 13, 2010  
Special Edition Seminar  
Health Care: Crisis or Solution?  
*How Recent Health Care Legislation Will Affect You And Your Business*

Owl Creek Country Club  
Registration 7:30 AM  
Seminar 8:00 AM – 10:00 AM  
Refreshments Provided

Please make your reservations by Tuesday, May 11, 2010 in one of the following ways:

Call Donna at 502.585.1600

Email [rsvp@strothman.com](mailto:rsvp@strothman.com)

If you have any questions, please call us at 502.585.1600 or email [info@strothman.com](mailto:info@strothman.com)

Please invite friends and associates to attend this seminar. This Strothman & Company seminar is designed to qualify for two hours of Continuing Professional Education for CPAs.

Directions to  
Owl Creek Country Club  
12400 Osage Road

From Hurstbourne and Shelbyville Road: On Hurstbourne turn east on Shelbyville Road. Go to the 6<sup>th</sup> stoplight (Evergreen Road) and turn left. Go through 3 stop signs. At the 3<sup>rd</sup> stop sign, drive directly across the road and over the railroad tracks. After the tracks, take a right on the 3<sup>rd</sup> street on the right (Osage Road). Follow Osage around about ¼ mile to Owl Creek Country Club.

From Hurstbourne Parkway: Take Hurstbourne Pkwy to the 146 exit, which is LaGrange Road. At the bottom of the exit turn left at the stoplight. Go approximately 1 ½ to 2 miles to stop sign. Go through the stop sign and turn right at Anchorage Post Office. This street will fork to the left and right at Evergreen Rd. Take the left fork and then make the immediate right (Osage Road). Follow Osage around to Owl Creek Country Club

From Downtown: Take 64 East to 265 North (Gene Snyder) to the 3<sup>rd</sup> exit, Anchorage – Pewee Valley. At the bottom of the ramp, turn left and go approximately ¾ of a mile and turn right onto Lucas Lane and cross railroad tracks. Staying straight on Lucas Lane, go to 2<sup>nd</sup> stop sign and turn left (Osage Road). Owl Creek Country Club is about ¼ mile on the right. More details and directions to Owl Creek can be found at <http://www.strothman.com/>.

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If you have any questions, please call us at 502.585.1600 or email [info@strothman.com](mailto:info@strothman.com)



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