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Tax & Business letter
FALL 2022

# The power of comparative financial statements

Your business has a story to tell. And one of the ways to hear your business's story is by reviewing performance through comparative financial statements.

## Pretty important stuff

An up-to-date balance sheet, income statement and statement of cash flows are essential financial reports filled with great information. But these financial statements by themselves don't tell the whole story about your business. Consider the following:

- **Liquidity Company, Inc.:** The current balance sheet shows $1 million in liquid assets with zero liabilities.
- **Big Profits, LLC:** The current income statement has a net profit margin of 35%.
- **We've Got Cash, Inc.:** The statement of cash flows shows that the company has consistently brought in more cash than it has spent over the past three years.

And here's the rest of the story:

- **Liquidity Company, Inc.:** Liquid assets decreased from $5 million to $1 million over the past 12 months.
- **Big Profits, LLC:** Net profit margin is typically 20% for this company. However, a recent round of layoffs temporarily pushed total salaries and wages lower, thus pushing the net profit margin higher.
- **We've Got Cash, Inc.:** There has been a steady decline in cash flow over the past three years.

The key in all this is the need to compare your financials to something that provides clarity to how you feel about the results.

## Building your comparative financial statements

▶ ***Step 1: Determine your comparative reporting.*** A standard set of comparative financial statements often includes the following:

- Current performance versus prior period actuals
- Current performance versus plan
- Current performance versus forecast

▶ ***Step 2: Consider the timeframe of your comparative financials.*** The timeframes to consider are:

- Monthly (versus last month and same month last year)
- Year-to-date
- Full-year forecast

▶ ***Step 3: Build your comparative reporting.*** Be sure it includes:

- A dollar change column
- A percent change column
- Internal percentages as a percent of sales (income statement) and percent of total assets and/or liabilities (balance sheet)

## Focus on analysis

The reports themselves can be a daunting array of numbers. So when reviewing each report, try to focus on a few key items of change. Here are some suggestions on changes to note:

- Changes in sales or areas of sales
- Cost of goods sold as a percent of sales and how it is changing
- Gross margin percent
- Net income percent
- Advertising and discounting as a percent of sales
- Personnel as a percent of sales and how it is changing over time
- Identify the top five expenses and see how they change as a percent of sales
- Cash flow as a percent of sales and how it changes over time
- Current assets and current liabilities
- Changes in debt versus equity
- Identify key drivers of cash flow and see how they change over time or versus plan

# IRS TAX NOTES

## IRS warns businesses of spear phishing attacks

The IRS is warning businesses to be on the lookout for spear phishing, which is the fraudulent practice of sending emails, usually from a known or trusted sender in order to trick the targeted individual into revealing confidential information.

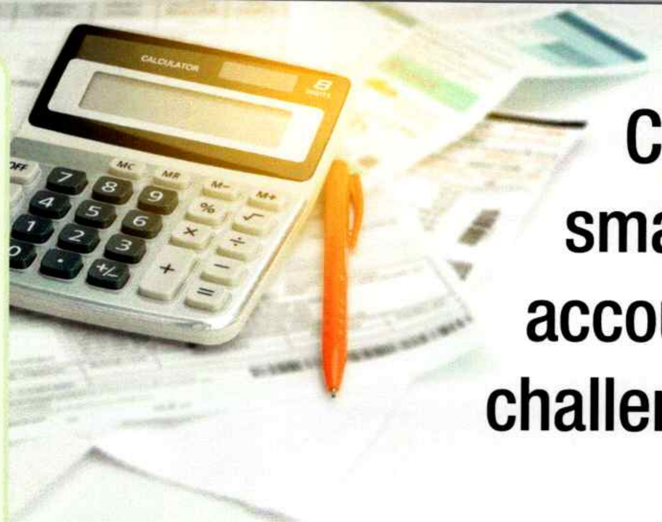
IRS Commissioner Chuck Rettig emphasized that spear phishing remains one of the biggest threats to businesses, as it can be tailored to attack any type of business or organization. So remind everyone to be on alert when a strange email pops up in their inbox.

Recent IRS phishing emails use the IRS logo and a variety of subject lines such as "Action Required: Your account has now been put on hold." And yet other emails include malicious links or attachments that steal information or download malware onto the organization's systems.

## Interest rates increase for fourth quarter of 2022

Interest rates for the fourth quarter in 2022 will increase compared to last quarter. These rates include: 6% for overpayments (5% for corporations); 3.5% for the portion of a corporate overpayment over $10,000; 6% for underpayments and 8% for large corporation underpayments.

Under the Internal Revenue Code, the rate of interest is determined on a quarterly basis. For taxpayers other than corporations, the overpayment and underpayment rate is the federal short-term rate plus 3 percentage points. ♦




# Common small business accounting challenges

Keeping your company books in order can be a challenge. Consider these common accounting situations often seen when preparing business tax returns to ensure they do not happen to your business:

**1 Mixing in personal expenses.** Having non-business costs included in your business accounts can create several challenges. First, your financial statements will not accurately portray your business performance. Second, personal expenses are a drag on your available cash. Third, the IRS is quick to deny legitimate business expenses as tax deductions if it perceives that personal expenses are blended with business expenses. Common sources of non-business expenses to watch for are charges you make on credit cards and expense reimbursements to owners.

**2 Not keeping your books current.** Waiting too long to record information in your accounting system actually requires more time to get back on track. Complex entries get even more complicated as your ability to recall transaction details diminishes over time. Set a goal to have all transactions entered every week at a minimum.

**3 Entering capital assets as expenses.** Because capital assets provide long-term value, they are entered on the balance sheet and depreciated over multiple years. Misclassifying a capital asset as an expense will torpedo your net income for that period and potentially create an audit problem. To avoid this, review large purchases and comb expense accounts likely to be hiding capital assets during your month-end review.

**4 Not performing timely bank reconciliations.** When you receive your bank statements, ensure they are reconciled to your books within a week or two. Bank reconciliations almost always identify errors. Delaying bank reconciliations will add unneeded complexity and decrease your chances of correcting an error in a timely manner.

**5 Mishandling sales tax.** Many businesses incorrectly record sales tax they receive as revenue. Sales tax you receive should be entered as a liability until you remit it to the proper tax authority, ultimately avoiding your income statement altogether. This is because it is not your money. You are holding that money in trust for each respective state. On the other hand, sales tax you pay on purchases should be booked as an expense.

**6 Lacking proper documentation.** Most business owners know that you need to save invoices and receipts for sales and purchases, but what about documentation for adjustments and journal entries? Proving these is just as important. Contracts, time sheets and shipping documents are some examples of substantiation that can help support your journal entries.

**7 Devoting too much of your time.** Most entrepreneurs start their business for reasons other than spending hours working on their books. Don't get bogged down worrying about the inner-workings of accounting rules and tax laws. Partnering with an expert to handle your accounting needs can free you up to use your expertise where it's needed the most – running and growing your business. ♦

# Dos & Don'ts of small business IRS audits

The best way to deal with an IRS audit of your small business is to know what to do and what not to do. Consider the following:

## Be professional

**✓ DO** Auditors have a job to do, and it's in your best interest to show them respect. If you're called to their office, show up on time, dress appropriately and have requested documents in hand. If auditors visit your place of business, encourage staff to answer questions honestly and completely. Within reason, it's acceptable to ask for more time to locate a particular record. If you can't find supporting documentation, say so.

**× DON'T** Avoid arguing with the auditor. Ask for clarification if needed, but don't question every document request. If you disagree with the auditor, state your case and understand you have appeal rights should the disagreement become costly.

## Be organized

**✓ DO** If you keep business records on a computer, know how to create and print easy-to-follow reports. Prepare for the audit by laying out checks, invoices and other records in a logical fashion.

**× DON'T** Avoid dumping a box of receipts into an auditor's lap. The easier it is for an auditor to find what they need, the shorter the time period required to complete the audit. Remember, the longer an auditor spends with your records, the more likely he or she will find something amiss.

Also keep in mind that it's rarely a good idea to create records during an audit. Exceptions may be if you're honestly trying to reconstruct transactions from memory or your records don't exist (for example, after a natural disaster or fire). IRS agents are often suspicious of hastily-prepared documents that smell of wet ink.

## Be honest

**✓ DO** Make a straightforward effort to justify deductions. If you can't locate a specific record, look for alternative ways to support your tax return. For example, if you're claiming a deduction for depreciation but can't locate the paperwork, redo the calculation for the auditor. A vendor, landlord or mortgage company may have copies of pertinent records if yours have gone missing.

**× DON'T** Never create numbers that can't be corroborated or reasonably explained.

## Ask for help

**✓ DO** Get an expert in your corner if you're facing an audit.

**× DON'T** Don't ignore your need for help. Remember, auditors conduct audits all the time. This is a rare event for you. Be sure to ask for help! ♦

# CASH FLOW CORNER

## 5 ideas for better cash flow management

Focusing solely on sales and profits can create a surprise for any business when there is not enough cash to pay the bills. Here are five ideas to help improve your cash flow management.

**1. Create a cash flow statement and analyze it monthly.** The primary objective of a cash flow statement is to help you budget for future periods and identify potential financial problems before they get out of hand. Simply prepare a schedule that shows the cash balance at the beginning of the month and add cash you receive (from things like cash sales, collections on receivables, and asset dispositions). Then subtract cash you spend to calculate the ending cash balance. If your cash balance is decreasing month to month, you have negative cash flow and you may need to make adjustments to your operations. If it's climbing, your cash flow is positive.

***Bonus Tip:*** *Once you have a cash flow statement that works for you, try to automate the report in your accounting system. Or even better, create a more traditional cash flow statement that begins with your net income, then make adjustments for non-cash items and changes in cash driven by your balance sheet accounts.*

**2. Create a history of your cash flow.** Build a cash flow history by using historical financial records over the course of the past couple of years. This will help you understand which months need more attention.

**3. Forecast your cash flow needs.** Use your historic cash flow and project the next 12 to 24 months. This process will help identify how much excess cash is required in the good months to cover payroll costs and other expenses during the low-cash months. To smooth out cash flow, you might consider establishing a line of credit that can be paid back as cash becomes available.

**4. Implement ideas to improve cash flow.** Some ideas include:

- Reduce the lag time between shipping and invoicing
- Re-examine credit and collection policies
- Consider offering discounts for early payment
- Charge interest on delinquent balances
- Convert excess and unsold inventory back into cash

**5. Manage your growth.** Take care when expanding into new markets, developing new product lines, hiring employees, or ramping up your marketing budget. They all require additional cash. ♦

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# Getting a handle on employee turnover

If you've ever lost a key employee, you know the immediate and long-term hit to your bottom line. Here are some steps you can take to reduce employee turnover and the challenges it brings:

- **Review employee compensation.** Do your homework to ensure your company is offering competitive industry salaries and benefits for your area. Consider making pay adjustments to key employees that would be hard to replace.

  Also review benefit packages. Many of your competitors may be offering additional vacation, enhanced family leave and other benefits. A good way to look at this expense is to balance the additional cost against the cost of replacing one or two key employees.

- **Talk with employees about what keeps them satisfied.** An IBM workplace study found that the priorities of employees across working generations align on major job-related issues, including fair treatment, growth opportunities, flexible work hours and their work making a positive impact.

  During performance reviews, ask your employees about their priorities. This will give you insight into what retention strategies are working well at your company, or tip you off on why employees may end up leaving. Anonymous surveys may also be an effective way to gauge the satisfaction of your employees.

- **Offer career paths to employees who want them.** Chances are if employees feel stuck in their job roles they'll go looking for opportunity elsewhere. Show the ambitious employees at your company that their desires for career development are heard by offering them more responsibility and trust in their roles. This could come in the form of additional assignments outside of their usual scope, plus more autonomy.

- **Cross-train employees in key functions.** This not only offers employees new challenges and a chance to develop more skills, it also provides you with the comfort of knowing that key positions can be temporarily backfilled should someone leave unexpectedly. ♦

## Tax CALENDAR

FALL 2022

### October 17

- ❑ Filing deadline for 2021 individual and calendar-year C corporation tax returns on extension.

### 4th Quarter

- ❑ Estimate your 2022 income tax liability and review options for minimizing your 2022 taxes. Call to schedule a tax planning review.



**We appreciate your business.** Please call any time we can be of assistance to you in your tax, financial, or business affairs.

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