

# PRACTITIONERS FORUM

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## Measuring profits: How much is enough?

*Assisting a client in getting a loan is one of the more important services a CPA provides for a client. Hans Kasper, CPA, 19755 Greenview, Mokena, Illinois 60448, provides some insight into a situation that others might have to face.*

A CPA is called on by his client to discuss the feasibility of expanding the company's capacity by purchasing additional equipment to capture a new market for the client's product. The client had already contacted his banker who, based on the client's credit history and current financial statements, gave the client a preliminary approval for a \$250,000 loan, repayable in monthly installments over five years. Final approval was subject to endorsement of the client's written loan proposal by the bank's board.

The CPA provided his client with a written loan proposal that included projections of revenues, expenses and profits for the next five years plus break-even figures, product pricing, return on investment and a discounted payback analysis. The client decided that the proposal was within acceptable risk tolerances as the equipment was estimated to have a 10-year life and a 6.5-year payback.

The client submitted the proposal, but the bank returned it stating that it would reconsider the proposal when it had received a yearly analysis showing the client's ability to earn profits and to generate cash flow sufficient to repay the loan. The CPA realized that although the loan proposal was excellent, all of the techniques used in it assumed that the debt repayment period was equal in time to the life of the related assets. None of the figures presented in the proposal brought to light the disparity in cash flow that is created when the debt repayment period is shorter than

both the life of the related assets and, more significantly, the payback period.

The CPA's main concern then was to develop minimum profit figures sufficient to provide a cash flow that would be adequate to repay the debt and to compare these figures to projected profits. To accomplish this the CPA developed two schedules—schedule 1, page 32, reflecting minimum profits required before extra capacity, and schedule 2, page 32, minimum profits required after extra capacity. He explained to his client that these schedules tie together the profit projections and the payback analysis in the same manner that the statement of changes in financial position ties together the balance sheet and the income statement in a financial report. The client realized that the basis for these new schedules was similar to a statement of changes in financial position in reverse, something he understood from his prior use of financial statements.

## Minimum profit requirement schedules

Based on a review of schedule 1, minimum profit requirements before extra capacity, which shows projected net income to exceed minimum net income for each year of the data in the loan proposal and of the client's prior financial statements, the CPA concludes that the client should be able to meet his debt requirements through 1985 assuming that past and current trends continue.

Based on a review of schedule 2, minimum profit requirements after extra capacity, of the loan proposal data and of the client's prior financial statements, the CPA concludes that in 1981, 1982 and 1983 projected net income after extra capacity should be adequate since the figures exceed the minimum net income requirements. However, for 1984 and 1985 he concludes that, unless cash is accumulated from prior profits, sales are increased, expenditures are reduced and/or short-term borrowing is located, the client will not have sufficient cash flow to repay the debt since projected net income is less than minimum net income.

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## Schedule 1

### Minimum profit requirements before extra capacity

For the periods ending December 31

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Debt repayment	\$53,000	\$50,000	\$37,000	\$40,000	\$27,000
Depreciation	(15,000)	(15,000)	(15,000)	(15,000)	(15,000)
Minimum net income after income taxes	38,000	35,000	22,000	25,000	12,000
Income taxes	9,000	8,000	4,000	5,000	2,000
Minimum net income before income taxes	<u>\$47,000</u>	<u>\$43,000</u>	<u>\$26,000</u>	<u>\$30,000</u>	<u>\$14,000</u>
Projected net income before income taxes	<u>\$50,000</u>	<u>\$55,000</u>	<u>\$45,000</u>	<u>\$45,000</u>	<u>\$47,000</u>

## Schedule 2

### Minimum profit requirements after extra capacity

For the periods ending December 31

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Debt repayment—current	\$53,000	\$50,000	\$37,000	\$40,000	\$27,000
Debt repayment—additional	16,000	34,000	50,000	67,000	83,000
Depreciation—current	(15,000)	(15,000)	(15,000)	(15,000)	(15,000)
Depreciation—additional	(25,000)	(25,000)	(25,000)	(25,000)	(25,000)
Equipment purchased	250,000	—	—	—	—
Loan procured	(250,000)	—	—	—	—
Investment tax credit	(25,000)	—	—	—	—
Minimum net income after income taxes	4,000	44,000	47,000	67,000	70,000
Income taxes	1,000	11,000	13,000	23,000	25,000
Minimum net income before income taxes	<u>\$ 5,000</u>	<u>\$55,000</u>	<u>\$60,000</u>	<u>\$90,000</u>	<u>\$95,000</u>
Projected net income before income taxes	<u>\$60,000</u>	<u>\$70,000</u>	<u>\$70,000</u>	<u>\$80,000</u>	<u>\$80,000</u>

The CPA tells his client that these computations assume a zero change in cash position during each period to derive a minimum net income figure. However, if a certain dollar increase in cash is required, it could be added to the schedules. Also, although it is not shown in these schedules, consideration should be given to changes in balance sheet items other than depreciation, debt and cash.

The CPA also believes that some attention must be given to the correct placement of debt repayment and internally financed capital acquisition in the schedules. For example, should these items be considered as a part of 1982's minimum profit figure for a sufficient cash flow prior to 1983's requirements, or should they only be considered as a part of 1983's calculation? Furthermore, the addition of quarterly schedules might be significant over a short term, especially if repayments or acquisitions are scheduled in this manner.

The client must now analyze

the available data and the risk factors in light of these new projections. He must play "what if" by changing figures and strategies to adapt his revised proposal to a workable and realistic mold. And he must decide whether the expansion of capacity is feasible. Whatever the outcome, he now has the additional information which helps to tie together his previous data.

These are simplified examples of a CPA's actual schedules, and more in-depth analyses are usually prepared. But these schedules at least help the client take a partial look into the future.

### A tax credit versus an exemption: there's a difference

Professors C.W. Bastable, CPA, Ph.D., and Gerald P. Brady, CPA, 609 Uris Hall, Columbia University, New York, New York 10027, have discovered that many

practitioners do not know that the \$47,000 gift and estate tax credit is not always equivalent to a \$175,625 exemption. Here they tell why, adding a valuable table to show the differences.

If you've told your clients that the \$47,000 gift and estate tax credit under the unified transfer tax-rate schedule is equivalent to an exemption of \$175,625, you may have misinformed them.

The maximum credit of \$47,000 against combined gift and estate taxes has been cited frequently as equivalent to a unified exemption for gifts and estates of \$175,625. The equivalency presumably stems from the fact that \$175,625 is the amount on which the tax would be \$47,000—e.g.:

Tax on \$150,000	\$38,800
Tax on 25,625 @ 32%	8,200
Tax on <u>\$175,625</u>	<u>\$47,000</u>

Since a tax credit of \$47,000 negates any tax liability, it is

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**Table 1****Comparison of \$47,000 tax credit and unified gift and estate tax-rate schedules with \$175,625 exemption**

<i>Cumulative taxable gifts</i>	<i>Actual tax liability—after \$47,000 credit</i>	<i>Hypothetical tax liability with \$175,625 exemption</i>	<i>Difference in favor of exemption</i>	<i>Exemption that would yield the same tax liability as \$47,000 credit</i>
\$ 175,625	-0-	-0-	-0-	\$175,625
275,625	\$ 32,513	\$ 23,800	\$ 8,713	146,582
375,625	66,513	54,800	11,713	139,022
475,625	100,513	87,800	12,713	138,234
575,625	136,781	121,800	14,981	131,562
675,625	173,781	155,800	17,981	127,028
775,625	211,294	192,800	18,494	125,641
875,625	250,294	229,800	20,494	120,512
975,625	289,294	267,800	21,494	120,512
1,075,625	329,806	306,800	23,006	116,635
2,075,625	770,856	735,800	35,056	97,723
3,075,625	1,286,906	1,237,800	49,106	82,972
5,175,625	2,626,738	2,550,800	75,938*	67,143

Note: This table shows that when there is tax liability, a tax credit of \$47,000 is not equivalent to an exemption of \$175,625 as is frequently stated. At one extreme, the credit may be worth no more than an exemption of \$67,143.

\*Maximum difference attainable

assumed that the consequence is equivalent to exempting \$175,625 of taxable gifts. Actually, the exemption equivalency of the credit diminishes as cumulative taxable amounts exceed \$175,625. Due to unification of both gift and estate taxes, this can be demonstrated readily by dealing exclusively with gifts.

If there were a \$175,625 exemption instead of a \$47,000 credit, cumulative taxable gifts in excess of the exemption presumably would be taxed progressively, beginning with 18 percent, the lowest rate on the current tax-rate schedule. However, a credit does not work that way. All cumulative taxable gifts are subject to tax, but there is no tax liability on cumulative taxable gifts of \$175,625 because the tax of \$47,000 is offset by the \$47,000 credit.

The tax on gifts in excess of \$175,625 is computed at that point in the tax-rate schedule where the last computation stopped. Specifically, the next \$1 of gifts is taxed at the rate of 32 percent—not at 18 percent, the figure applicable to the first \$10,000 of taxable gifts.

Table 1, above, shows how

progressively more valuable a \$175,625 exemption is than a credit of \$47,000 when there are tax liabilities. For different amounts of cumulative taxable gifts, the table employs the current gift-tax schedule in two ways: (1) as required in 1981 and (2) as if there was a \$175,625 exemption instead of the \$47,000 credit. It should leave no doubt that a \$175,625 exemption would be preferable to a \$47,000 credit whenever cumulative taxable gifts exceed \$175,625. The fact is that the correct magnitude of an exemption equivalent to a \$47,000 credit clearly diminishes as tax liability increases. Consequently, the \$47,000 credit has a higher exemption equivalency for the low taxpayer than for the high taxpayer.

### Returns prepared on your own computer

Grace Wilford, 146 Harrison Street, Elyria, Ohio 44035, has had extensive experience in processing returns on in-house computers. As a result of this

*experience, she gives some excellent advice to those who are planning to process tax returns on their own computers.*

You can run a profitable in-house computer system, whether you prepare 300 or 3,000 tax returns, if you plan early, watch your scheduling and involve your entire staff.

### Early planning

Make a commitment long before the season begins to put every return possible on the computer. If this is your second year with your own in-house system, critically evaluate each return that was not done on the computer last year to determine if it can be done on it this year. An early commitment proves to your staff that you are serious about preparing the returns this way.

### Personnel and training

It's helpful to make a flowchart of the work, including the names of people qualified to function at each level. This will help you

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