SUMMER 2013

THE Quarterly Dividend

Vol. 22 No. 3 — Your guide to income tax & financial planning

FAST TRACK

Resilence

There is one quality that a business owner must possess if he is to be successful over the long term and that is the ability to recover from adversity. Resilience is the power to get back on your feet after encountering a situation that has had you "down" for a period of time. This can be a business set-back where you have lost an important client who has been responsible for a major part of your billings (and that is why it is never a good thing to have a large percentage of your revenues coming from only one

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Take this Income Tax Savings Challenge!!

If you are an employee, every February you will receive a statement from your employer outlining the amount of earnings that were paid to you during the previous calendar year and any amounts that had been deducted "at source".

The form is termed a T4. At a minimum it will reflect your gross employment earnings (Box 14) and the amounts your employer deducted regarding contributions to the Canada Pension Plan (Box 16), payments remitted to Canada Revenue Agency regarding Employment Insurance (Box 18) and income taxes withheld (Box 22).

If you are a member/contributor of a company pension plan or union, you will see the appropriate amounts that had been deducted from your pay and sent to the respective governing bodies (Boxes 20 and 44). Any charitable donations made through payroll will be shown in Box 46.

In many cases the amount that is shown in Box 14 will include more than your actual cash earnings during the year. It will include certain "taxable benefits" that have been allocated to you by your employer. They are totaled in Box 40 but not specifically listed.

Now do the following: (a) examine your 2012 T4 slip and see if any amounts were included in Box 40. If so, they are already included in Box 14 and consequently will be included in income on your income tax return; (b) look at the accompanying table. The left side outlines the most common taxable benefits that accrue to an employee at his place of work. See if any of the categories apply to you. Don't know or aren't sure? Contact your payroll department to determine how the amount reflected has been calculated; (c) look at the accompanying table again. The right side outlines any income tax deductions or credits to which you may be entitled based upon the taxable benefits that have been charged to you. See if you qualify for any of these and the amounts involved; and (d) amend your 2012 personal income tax return (by correspondence with the Canada Revenue Agency) to take advantage of savings that you did not know were coming your way.

	TAXABLE BENEFIT ADDED TO T4		POSSIBLE OFFSETTING CREDIT/DEDUCTION
(a)	tuition fees paid by employer or re-imbursed for courses not related to the employer's business	(a)	tuition tax credit and education amount
(b)	employer provided scholarships to employees (but not children of employees)	(b)	tuition tax credit and education amount
(c)	board and lodging	(c)	no offsetting deduction
(d)	rent-free and low-rent housing	(d)	no offsetting deduction
(e)	worker's tools	(e)	capital cost allowance
(f)	premium under provincial hospitalization or medical services programs	(f)	medical credit
(g)	personal use of employer's auto calculated as "standby charges" and "operating costs"	(g)	no deduction
(h)	sickness, accident or disability payments	(h)	no deduction
(i)	interest free or low-interest charges that are at less than government "prescribed rate"	(i)	no deduction
(j)	home relocation loan due to change in work location	(j)	moving expenses deduction
(k)	moving expenses for moves over 40 km	(k)	moving expenses deduction

Compliments of

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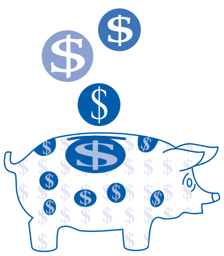


source) or a personal set-back due to illness either to yourself or a member of your family. Other adversities include business losses due to theft, fraud, natural causes such as inclement weather, changes in technology that you did not see coming into prominence so quickly, and other factors operating within your particular business environment.

An owner/manager may be able to anticipate certain "business changing" events and take the necessary precautions to minimize their effects once they occur. There are consultants who specialize in "disaster recovery" scenarios. They look at your business, assess your most vulnerable areas and determine "what-if" simulations. Then they suggest certain plans and procedures to be enacted now so that you will be ready if and when necessary.

Most of us remember Y2K. The news media and so-called experts throughout the world predicted catastrophic fallout from computers that could not keep up with changing from the 20th to the 21st century. Much money was spent in upgrading computer systems and developing contingency plans should computers fail. Fortunately, from hindsight, we now know that this was largely over-blown, but maybe it appears to be the case only because owner/managers an-

Restrictive Covenants

As a company grows and requires financing beyond which the owners of the business can furnish on their own, it looks to outside sources for funds. At the beginning, when borrowing needs are modest, the banker will require the owner(s) of the company to "put up" security for the money that they are about to be lent. This usually takes the form of "personal security" whereby the owner(s) pledge to the bank that they will repay the lending institution should the business in and of itself be unable to do so.

It is a common fallacy that company owners should incorporate their businesses prior to taking on certain obligations. This is usually advised before their taking on debt financing or entering into a lease agreement with a landlord, not to mention certain "in trust" accounts such as payroll and HST remittance obligations. It is argued that since the corporation and its owners are separate entities under law, the obligations of one end where the obligations of the other commence. Therefore, should the "unthinkable" happen and the corporation go bankrupt, the shareholders and directors themselves will still be in the clear and not responsible for debts previously incurred through the business. Unfortunately, this is not the case. Directors and in some cases shareholders will still be called upon to "make good" on the liabilities despite the corporate format that had been set up.

As far as the borrowing of money is concerned, the bank will require personal guarantees from the directors before the loan proceeds are advanced.

Over time, the amount borrowed will likely rise due to changes in the business. During its years of growth, the company may need to purchase increasing amounts of inventory, for example, or invest in updated capital assets. It may also need to finance accounts receivable as a growing customer base usually requires the issuance of credit to customers if larger contracts are to be signed.

At some point, when borrowings become sufficiently large, the bank will monitor their loan on a more frequent basis and demand certain conditions be met or maintained if they are to continue advancing funds. From their point of view, the more funds advanced to a company, the more they "are on the hook" should the business fall upon hard times and cease to operate.

The conditions required by the lending institution are termed "restrictive covenants". They require the business to maintain certain "ratios" or benchmarks in order to continue their current loan position or qualify for additional funds should they be requested.

There are many different ratios that the lending institution might require. The accompanying example will go through a sample lending process.

SAMPLE CORPORATION INC.
BALANCE SHEET
JUNE 30, 2013

ASSETS

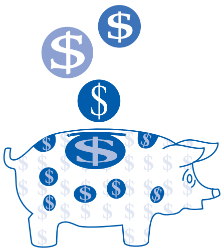
	$	$
Current Assets		
Cash	2,000	
Accounts receivable	12,000	
Inventory	40,000	54,000
Property, Plant and Equipment		
Machinery and equipment	70,000	
Less: Accumulated amortization	14,000	56,000
		110,000

LIABILITIES

Current Liabilities		
Bank loan	20,000	
Accounts payable	14,600	
Income taxes payable	1,400	36,000
Advances from Shareholders		49,000
		85,000

SHAREHOLDERS' EQUITY

Stated Capital		
100 common shares	100	
Retained Earnings	24,900	25,000
		110,000



ticipated the worst and took precautions in advance to prevent and minimize their effects.

Unanticipated set-backs, by definition, happen without warning but there are certain things you can do today to mitigate their effects should they occur. The most common is "business interruption insurance" that reimburses businesses some portion of losses incurred due to theft or fire. The maintenance of good accounting records will make it easier to calculate the monetary loss. Adjusters will look at how the business was "doing" for the period(s) before the loss was incurred and attempt to estimate (typically on the low side) what the business would have done had the loss not been sustained. Proving a claim will be time consuming with a lot of paperwork, but the funds received will help you get back to normal earlier than you would have without them.

It may take longer to recover from losses incurred due to illness or injury, but once again there are precautions that can be taken now to lessen the blow should the unthinkable happen.

The hiring of a smart, dedicated staff will be invaluable in these circumstances. Make it clear to all employees that "so and so" will take over your duties during your absence. Make sure that he/she has sufficient banking authority to carry on day-to-day

Page 2 shows the financial statements of Sample Corporation Inc. for the year ended June 30, 2013. As you can see, they are currently "into the bank" for $20000.

Management would like to increase their loan by $10000 to take advantage of an opportunity to purchase additional inventory at a very favourable price.

Let's examine the bank's likely "thought process" in their consideration of this loan application.

(a) Sample Corporation Inc. is a family owned company whose shareholders are Mr. and Mrs. Jones

(b) the company has a history of profitability (notice corporate retained earnings of $24900)

(c) management has kept prior years' earnings in the company and not withdrawn them (retained earnings)

(d) the company's major assets are inventory and equipment (inventory $40000 and book value of equipment $56000)

(e) the company's major liabilities are the bank loan currently $20000 and trade liabilities of $14600

(f) the shareholders have advanced personal loans to the company displaying confidence for the future (notice and Advances from Shareholders of $49000)

(g) general financial analysis can identify possible problem areas to determine whether they will be able to pay back the additional loan:

(i) net working capital is the excess of current assets over current liabilities and is measured by the "current ratio"

current assets	$ 54000	150%
current liabilities	$ 36000	

this rating is very good

(ii) consider only the most available and "objective" assets termed the "quick ratio"

cash & accounts receivable	$ 14000	40%
current liabilities	$ 36000	

this rating is not very good

(iii) refine the analysis by eliminating the accounts receivable that may take awhile to collect termed the "cash ratio"

cash	$ 2000	6%
current liabilities	$ 36000	

this rating is poor

ANALYSIS:

(1) company has strong management and a proven record of profitability

(2) company has sufficient available assets to pay its immediate debts if inventory on hand is turned over quickly and accounts receivable are collected within 30 days

(3) bank loan is currently $20000 and customer is seeking $10000 more

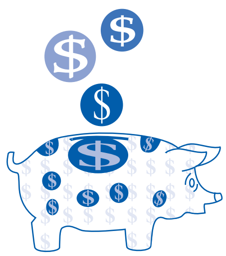
DECISION:

(1) approve bank loan due to strength of management and history of corporate responsibility

(2) demand "restrictive covenant": Company must show purchase invoices to bank to support the additional inventory of $10000 and shareholders must maintain current level of advances to the company of $49000 or greater

(3) both shareholders to sign "personal guarantees" for the $30000 loan

(4) company to provide quarterly financial statements to monitor adherence to restrictive covenant



activities. Introduce him beforehand to your main customers and suppliers. While he cannot be expected to run the operations in exactly the same manner as you would have were you "around", if he can at least keep the business going until you get back on your feet, you will not have fallen that much behind.

Another aspect of resilience is the opportunity to enact true and meaningful changes both personally and business-wise. Once the initial problems have been resolved and business is back to normal, look beyond simply putting the pieces back together as they used to be. Perhaps there is a different way of doing things that you never considered before. Now is the perfect time to try it out. Resilience is not the same as starting over. It can be the act of building on what you already have and tweaking it slightly to achieve results that you never believed possible.

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Employee Fraud

Employee fraud is defined as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's assets". Here are its characteristics:

(a) **who:** the individual committing the fraud is likely to be someone between the ages of 31 and 60. Both men and women commit fraud in approximately the same numbers;

(b) **what:** stealing or misusing the employer's resources. See examples below;

(c) **when:** statistics show that 10% of all employees are completely trustworthy and would never steal, no matter what. Another 10% of all employees will steal at any opportunity. The remaining 80% can "go either way".

If they rationalize that the employer has been mistreating them or not recognizing the value they are bringing to the organization or will simply never "miss" the funds that they are pilfering, they are prone to taking advantage of weak corporate internal controls or figuring out ways they can be bypassed;

(d) **where:** employee fraud is pervasive and can impact any business no matter what size or industry;

(e) **why:** all frauds will continue until they are uncovered because the typical fraudster is dependent upon the money "generated" to support a particular lifestyle or habit to which he has become accustomed. No one committing a fraud tells himself that he has stolen "enough" and will now revert to the way things used to be;

(f) **how:** most employers and employees realize that a certain amount of trust is needed in an organization if it is to function smoothly. Management cannot perform all tasks by themselves and must delegate duties to "trusted" employees under the assumption that they will act in the interest of the organization. Frauds occur when this trust is abused and the employee acts to his own advantage.

Frauds frequently occur as follows: (i) fraudulent billing – organization pays for products or services that it does not need. This is accomplished by an employee purchasing personal items directly through the company or by setting up a sham company to act as a supplier to the company thereby allowing the purchase of products or services; (ii) stealing of non-cash assets – this involves the outright theft of inventory from a warehouse or storeroom or the misuse of confidential information gathered on the job. The employee may also use company assets for personal purposes, including competing directly with the employer; (iii) cash skimming – involves the taking of cash before or after it has been recorded on the "books" of the company; (iv) expense account abuse – employee submits false expense claims by requesting re-imbursement of expenses that were either never incurred or were incurred for personal purposes. In other cases, the expenses may be fictitious, duplicated or simply overstated; (v) payroll schemes – these include claims for overtime that was never worked or adding a "ghost employee" to the payroll; (vi) tampering – forged signatures on company cheques, purchase orders or receiving slips; and (vii) corruption (sometimes only possible by collusion among several employees) – receive or offer bribes, accept or extort illegal payments or engage in other conflicts of interest.

Fraud prevention: (a) conduct reference checks on prospective employees; (b) segregate duties amongst employees so that no employee checks his own work and is responsible for all facets of a corporate transaction; (c) have proper physical security over warehouses and other places where inventory is stored; (d) perform bank reconciliations of all bank accounts and monitor cheques for authorized signatures; (e) have management personally hand-out payroll cheques rather than direct bank deposits of net salaries and wages; (f) video surveillance; (g) set up proper expense claim forms, allow re-imbursement of expenses only upon presentation of original receipts, ascertain management approval of expenses before they have been incurred by the employee; (h) reward employees who discover and report fraud as soon as they become aware of its existence. Most frauds are only detected by accident, well after they have been going on for some time.

What happens next: After a fraud has been detected and the offending employee discovered. Ask yourself three questions: (1) how did the employee benefit and to what extent? (2) how much did the company lose? and (3) how did the employee manage to cover it up? Most fraudsters, once discovered, promise to repay the company for all losses incurred. Some employers, rather than "go public" agree to an arrangement, which may or may not allow the employee to continue working for the organization. Other employers contact the police and proceed with criminal proceedings. In some cases, the company has insurance to cover fraudulent acts. The company will be re-imbursed for quantifiable losses and the insurance company will go after any parties (including the company's accountants) to make up for the claims they had to pay out.