RKFISCHER AND ASSOCIATES

Financial Management I

AGENDA

01 **FINANCIAL MANAGEMENT OVERVIEW**

02 **FINANCIAL STATEMENTS**

03 **CAPITAL COST ALLOWANCE & DEPRECIATION**

Financial Accounting

- Financial Accounting is the recording, maintaining, as well as reporting on the financials of a company. These are developed for external use.
- Management Accounting identifies the requirements of management and develops both financial and non-financial information that helps management / directors within the business make decisions going forward. These are for internal use.

Financial Management

Manages the finances and economic resources of the business which aids in better decision making for the business.

- Create wealth for the business and investors
- Generate cash
- Using Organizational resources efficiently

Key elements of financial management

- Financial planning
- Financial control – ensures efficient utilization of business assets
- Financial decision making – Investment , financing options, dividends – make sure business generates a good return on investment

Differences in Financial Management and Accounting

Graphic from WallStreet Mojo

https://www.wallstreetmojo.com/accounting-vs-financial-management/

Small Business Structure

- Most small businesses that are under 2.5M do not have an accountant on staff in their business.
  - They should employ a good bookkeeper
  - They have an external accountant do their taxes and perform annual compilations.
- Usually at around 2.5M we recommend that a business has a controller
  - Depending on background and experience of the accountant – they may make some of the treasury decisions working with the external accountant.
  - This can also differ by industry that you work
- Usually you will not see a separate treasury function in a small business unless there are multiple businesses or there is international business

Small Business Structure

- CFO function may exist in larger small businesses or those that are looking to become public down the road. They may have a controller and treasurer function underneath.
  - Much of this depends on the type of business. Many times you will see a CFO in a manufacturing or high tech businesses that are doing business in multiple countries or have high financing requirements.
- Board of Advisors
  - Business professionals that provide advice on how an owner can better manage their business. Some businesses have them performing executive functions. This is not a legally defined group like a board of directors.
    - ✓ Hand picked by the owner or owner/management team

Small Business Structure

- Board of Directors (should have a 5M and above)
  - Selected by shareholders and they have legally defined responsibilities
  - Governed by corporation bylaws
  - Responsible for Corporate Governance
  - Involved in the strategy of the business
  - Volunteer role for non-profit
  - There is liability attached if you are a board member
    - ✓ Insurance usually paid for by the business to cover liability
  - Make certain decisions for business
  - ** Non-Profits must have Board of Directors in Canada
    - ✓ Must have a minimum of 3 directors and 3 members

Financial Statements - Small Business

Small Business Accounting

- Most accountants will use ASPE (Accounting Standards for Private Enterprises) for small businesses versus IFRS (International Financial Reporting Standards) for preparing financial statements
  - When IFRS might be used versus ASPE for a small business
    - ✓ Company plans to go public (must be IFRS to be on stock exchange)
    - ✓ International investment that requires that you use IFRS
- IFRS requires additional reporting and treats some assets differently than ASPE.
- IFRS is where some of the strictness in financial statements comes from

Small Business Accounting

- Chart of Accounts for the Business should be set-up in relationship to how the business runs and how the owner wants to look at reporting.
  - Example: If there are multiple revenue sources that have different margins you might want to break out your revenue and costs associated with each product or services or group of products and services.
    - ✓ Hair Dresser with Aesthetics, Hair, and Products (shampoo, makeup....etc)
  - A manufacturing business chart of accounts will look very different than a chart of accounts for restaurant. (Revenue and Cost of Good items would be very different)

Chart of Accounts

- Your chart of accounts should be set up to reflect how your business is set up.
  - Income Statement Items
    - ✓ Revenues– you may have one or multiple operating lines so you could have multiple accounts that roll up to Revenues
    - ✓ Expenses – these are operating expenses that you spend typically on a monthly basis and are deductible. (not all 100%). (see examples list later)
      - Rent, Salaries, Advertising, Utilities ….etc.
    - ✓ Cost of Goods Sold – these are costs that are matched to related sales and include those costs directly attributable to the sale of the product.
      - Purchases, Labour, Inbound Shipping, Product Packaging …etc

Chart of Accounts

- Balance Sheet Items
  - ✓ Assets – Assets are things you have/own that add value to your business. Under assets you have Current Assets and Non-Current Assets
    - Current Assets: (Current year)   Cash & Cash Equivalents, Accounts Receivable, Prepaid Expenses, Inventory, Marketable securities
    - Non-Current Assets: (Longer than one year) Investments (over a year) , property, plant and equipment , intangible assets
  - ✓ Liabilities – Liabilities are obligations or debt that the business owes. There are Current Liabilities and Non-Current Liabilities .
    - Current Liabilities (plan to pay within year), Notes payable, customer deposits/prepayments, accounts payable, portion of loan that must be paid in current year, wages payable, interest payable, income taxes payable, accrued expenses payable
    - Non-Current Liabilities (longer than one year to pay off): long-term loans, shareholder loans, bonds payable, deferred compensation, deferred revenues , deferred income tax

Financial Statements

- Income Statement
  - Also known as the profit and loss statement focuses on business revenue and expenses for a set period of time.
- Balance Sheet
  - Also known as statement of financial position focuses on the assets, liabilities, and equity of a business for a set period of time. It details the balance of income and expenditures from the proceeding period.
- Cash Flow Statement
  - Also known as a statement of cashflows shows how changes in both the income statement and balance sheet affects cash in your business. There are three areas analyzed: Operating, Investing, and Financing Activities.

What is Included in the Income Statement

- REVENUE
  - List all of the Products, Services or Categorizations of Revenue
- COST OF SALES
  - Cost of Goods Sold (variable costs) (costs to make goods)
    - ✓ Beginning inventory (if you are storing inventory on shelves) – Ending of last year
    - ✓ Add Purchases associated with making the product or packaging
    - ✓ Add Freight-In – Freight that you pay for incoming purchases
    - ✓ Direct Labour – Labour associated with producing the product.
    - ✓ Other Direct Expenses (will differ by business)
      - In some businesses utilities may be associated as variable which changes with the production of product
    - ✓ Minus Ending inventory from the year (if you are storing inventory on shelves)
  - Indirect Expenses (for a business like a service business)
  - Total Cost of Sales (Cost of Goods Sold + Indirect Expenses)

What is Included in the Income Statement

- GROSS PROFIT
  - (Revenue – Total Cost of Sales)
- GROSS MARGIN
  - (Gross Profit/Revenue)
- OPERATING EXPENSES(most used ones)
  - Advertising & Promotion
  - Amortization (Current Portion of intangible assets)
  - Bad Debt
  - Bank Charges and Interest
  - Credit Card Charges
  - Depreciation (Current Portion of tangible assets)

What is Included in the Income Statement

OPERATING EXPENSES (CONT)

- Dues & Subscriptions
- Insurance
- Interest Expense (financing)
- Legal and Professional Fees
- License and Fees
- Meals & Entertainment
- Office Expenses
- Vehicle Expenses

OPERATING EXPENSES (CONT)

- Payroll Taxes
- Rent
- Repairs & Maintenance
- Salaries, & Wages
- Supplies
- Telephone
- Travel
- Utilities

What is Included in the Income Statement

- TOTAL OPERATING EXPENSES
  - Sum of all of the Operating Expenses
- NET OPERATING INCOME
  - Gross Profit – Operating Expenses
- OTHER INCOME
  - Income that may not be directly related to the business such as rent from a tenant, gain on the sale of an investment
- OTHER EXPENSES
  - expenses associated with other income
- NET OTHER INCOME
  - Other income – Other expenses

What is Included in the Income Statement

- NET INCOME BEFORE TAX(EBT) =
  - Net Operating income + Net Other Income
- TAXES
  - The Current Year Taxes
- NET INCOME AFTER TAX(or Net Income)
  - Net Income before Taxes - Taxes

What is Included in the Balance Sheet

- ASSETS
  - CURRENT ASSETS
    - ✓ Cash and Cash Equivalents
      - Example: Cash in the bank, Short-term bonds
    - ✓ Accounts Receivable
      - What has been invoiced to your customers
    - ✓ Pre-Paid Expenses
      - Example: Insurance that is paid in advance for the whole year
    - ✓ Inventory
    - ✓ Marketable Securities (Short-term investments)
  - NON-CURRENT ASSETS
    - ✓ Property, Plant, Equipment
      - Also includes depreciation
        - Equipment
        - Furniture
        - Buildings and Improvements
    - ✓ Good Will (Usually seen when a business is being sold or was sold on balance sheet)
      - Patents, Trademarks, Customer Contracts ….etc

What is Included in the Balance Sheet

- LIABILITIES
  - CURRENT LIABILITIES (under 1 year)
    - ✓ Short-term Loans (under 1 year)
    - ✓ Line of Credit
    - ✓ GST/HST Payable
    - ✓ Payroll Tax Payable
    - ✓ Current Portion of Long Term loan Paid in Year
    - ✓ Current Portion of Mortgage Payable
    - ✓ Income Tax Payable
    - ✓ Interest Payable
  - NON-CURRENT LIABILITIES (more than 1 year)
    - ✓ Long Term Loan
    - ✓ Mortgage Payable
    - ✓ Shareholder’s Loan
    - ✓ Deferred Income Tax, Deferred Revenue

What is Included in the Balance Sheet

- EQUITY
  - Retained Earnings (from income statement)
  - Share Capital
- Assets = Liabilities + Equity

Cash Flow Statement

- **Cash Flow from Operating Activities**
  - Net Income (net/loss)
  - Current Assets (except marketable securities)
  - Current Liabilities (except loans or notes payable)
  - Depreciation
- **Cash Flow from Investing Activities**
  - Long term assets (fixed assets)
  - Marketable securities
  - Investments
- **Cash Flow from Financing Activities**
  - Long-term liabilities
  - Loan and Notes Payables (current liabilities)
  - Current Mortgage Payables (current liabilities)
  - Common Stock
  - Dividends

What Is Included in Cashflow Statement

- NET INCOME
  - Taken from the income statement
- DEPRECIATION / AMORTIZATION
  - Taken from income statement
- ADJUSTED NET INCOME
  - Net Income + Depreciation / Amortization
- OPERATING ACTIVITIES
  - Changes between current year and past year
    - ✓ NON-CASH CURRENT ASSETS
    - ✓ CURRENT LIABILITIES
  - NET CASH FLOW FROM OPERATING ACTIVITIES

What Is Included in Cashflow Statement

- INVESTING ACTIVITIES
  - Changes between current year and past year
    - ✓ NON-CURRENT ASSETS
  - NET CASH FLOW FROM INVESTING ACTIVITIES
- FINANCING ACTIVITES
  - Change between current year and past year
    - ✓ NON-CURRENT LIABILITIES
  - NET CASH FLOW FROM FINANCING ACTIVITIES
- NET INCREASE IN CASH
  - Sum of NET CASH FLOW from Operating, Investing, and Financing Activities
- CASH AT THE END OF THE YEAR
  - Cash at the Beginning of the Year + Net Increase in Cash

Debits/Credits and Inflows and Outflows

Inflows and Outflows

Accounts	Change in Account	Inflow / Outflow of Cash
Asset	+	Outflow
Asset	-	Inflow
Liability / Common Stock	+	Inflow
Liability / Common Stock	-	Outflow
Depreciation	add to income	Inflow
Dividends	subtract	Outflow

Debits and Credits

Account Type	Description	Contra	Debit	Credit
ASSETS	Current Assets (used in year or converted to cash		+	-
	Fixed (buildings, land, furniture, equipment)		+	-
	Other		+	-
	Accumulated Depreciation	Contra	-	+
LIABILITIES	Current (paid/settled within year)		-	+
	Long Term (loans or Bonds payable)		-	+
	Bond Discount	Contra	+	-
EQUITY	Capital + Owners Investments		-	+
	Profit/Loss Retained Earnings		-	+
	Owner's Draws	Contra	+	-
INCOME	Sales		-	+
	Service		-	+
	Returns & Allowances	Contra	+	-
COGS	Cost of Goods Sold		+	-
Expenses	Expenses		+	-
	Rebate	Contra	-	+
Other Expenses	Penalties or Fines		+	-
Other Income	Interest or Dividend Income		-	+

Cash Flow Statement Example

Net Income 2009	$141,100.00			
Cash dividends paid out	$154,200.00			
				Debit/Credit
ASSETS	**2008**	**2009**	In/Dec	+/-
Current Assets				
Cash	$25,200.00	$29,600.00	not relevant	
Accounts Receivable	$12,550.00	$12,900.00	in	-
Credit Card Receivables	$9,700.00	$8,000.00	de	+
Inventories	$2,850.00	$1,100.00	de	+
Marketable securities	$2,000.00	$3,000.00	in	-
Prepaid Expenses	$6,100.00	$4,200.00	de	+
Total Current Assets	**$ 58,400.00**	**$ 58,800.00**		
Property, Plant & Equpment				
Land	$ 194,000.00	$ 194,000.00	na	
Building	$ 9,800,000.00	$ 9,800,000.00	na	
Furniture	$ 184,000.00	$ 134,000.00	de	+
Equipment	$ 736,400.00	$ 803,400.00	in	-
Accumulated Depreciation	-$ 2,400,000.00	-$ 2,544,200.00	in	-
Total Net Property, plan & Equipment	**$ 8,514,400.00**	**$ 8,387,200.00**		
Other Assets	$ 509,000.00	$ 609,000.00	in	-
Total Asset	**$ 9,081,800.00**	**$ 9,055,000.00**		
LIABILITIES				
Current Liabilities				
Accounts Payable	$ 13,700.00	$ 15,700.00	in	+
Wages Payable	$ 4,200.00	$ 5,000.00	in	+
Notes Payable	$ 4,900.00	$ 3,700.00	de	-
Current Mortgage Payable	$ 15,300.00	$ 15,900.00	in	+
Total Current Liabilities	**$ 38,100.00**	**$ 40,300.00**		
Long-Term Liabilities				
Mortgage Payable	$ 7,710,200.00	$ 7,704,300.00	de	-
Total Liabilities	**$ 7,748,300.00**	**$ 7,744,600.00**		
Shareholder's Equity				
Common Stock	$ 960,000.00	$ 950,000.00	de	-
Retained Earnings	$ 373,500.00	$ 360,400.00	na	
Total Shareholder's Equity	**$ 1,333,500.00**	**$ 1,310,400.00**		
Total Liabilities and Shareholder's Equity	**$ 9,081,800.00**	**$ 9,055,000.00**		

OPERATING ACTIVITIES		
Net Income		$141,100.00
Depreciation	in	$144,200.00
Accounts Receivable	de	-$350.00
Credit Card Receivables	de	$1,700.00
Inventories	de	$1,750.00
Prepaid Expenses	de	$1,900.00
Accounts Payable	in	$2,000.00
Wages Payable	in	$800.00
Operating Activities		$293,100.00
INVESTING ACTIVITIES		
Marketable securities	in	-$1,000.00
Land	nc	$0.00
Building	nc	$0.00
Furniture	de	$50,000.00
Equipment	in	-$67,000.00
Other Assets	in	-$100,000.00
Investing Activities		**-$118,000.00**
FINANCING ACTIVITIES		
Notes Payable	de	-$1,200.00
Current Mortgage Payable	in	$600.00
Mortgage Payable	de	-$5,900.00
Common Stock	de	-$10,000.00
Dividends	in	-$154,200.00
Financing Activities		-$170,700.00
Cash Starting		$25,200.00
Total from Cash Flows		$4,400.00
Ending Cash Balance		$29,600.00

Trial Balance / Ledger / General Ledger

- LEDGER
  - This is book or file for recording and totalling accounting transactions (journal entries).
  - Also includes your chart of accounts.
    - ✓ If you have an accounting system – this is not really relevant, but there are some small businesses that do this on Excel and believe it or not hard books
      - Typically Soho businesses that are not incorporated. Tend to be older business owners and a lot of time older business owners of immigrant businesses. We have dealt with these where the children are looking to take over the business and get the business automated.
- GENERAL LEDGER
  - Grouping of accounts that are used to store information form a company's business transactions.
    - ✓ Contains all of the detailed transactions comprising all accounts in your system

Trial Balance / Ledger / General Ledger

- TRIAL BALANCE
  - List of all the accounts in your chart of accounts with the ending balance
    - ✓ Total of all the debits and credits
    - ✓ Sum of all debits = sum of all credits

Question on Negative Operating Cash Flow

- How long do you recommend a new company maintain a negative operating activity cash flow before there should be a cause for concern?
  - Will depend on the industry …….
  - General rule of thumb
    - ✓ Most investors (Angels / VCs) want to see a return on their investment within 2-3 year and want to see a profit within 5 and want out by then.
    - ✓ Banks are usually looking for a business to be cash flow positive within 2-3 years.
      - It is expected that for 2-3 years that businesses are running off shareholder loans, bank loans, or monies from third parties.
  - Available cash divided by your monthly cash burn rate will let you know how long it will take for you to go bankrupt, or seek additional funds.

Question Asked on Cash Flow Statement

- **Why is depreciation added to profit in cash flow statement?**
  - Depreciation is a non-cash item (there is no outgoing payment) and therefore is added back in.
  - Depreciation decreases the net book value of the asset and allocates the cost of a tangible asset over time. It allows you to expense the cost of the asset over time.
  - Depreciation on the income statement is an indirect operation expense which reduces the company’s gross profit but also lowers the company’s taxable income.
  - Operating cash flow starts with net income (profit) and adds depreciation/amortization back in which results in higher amount of cash on the cash flow statement.

Depreciation Versus Capital Cost Allowance

- Depreciation – allocated in the cost of the asset over a time that the asset is useful. Keep in mind it may be useful for a longer period of time than CRA lists. CRA defines classes of equipment with %.
  - Depreciation Expense – Amount of depreciation reported on income statement (current year)
  - Accumulated Depreciation – Total amount of depreciation that has been reported already on all income statements from the time the asset was purchased and is on the balance sheet
- You can choose to depreciate (internally) an item for a time you see fit that you will be able to use the item.

Depreciation Versus Capital Cost Allowance

- Capital Cost Allowance – The amount that CRA allows you to deduct assets over a period of time – the yearly deduction is called capital cost allowance.
  - If you are using CCA internally – what you calculate and what the CRA has you calculate could be 2 different calculations – why there are deferred taxes (two sets of books)
  - Depends on the type of property and date it was acquired.
  - Classes of assets - https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/sole-proprietorships-partnerships/report-business-income-expenses/claiming-capital-cost-allowance/classes-depreciable-property.html
  - CRA Calculation https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/sole-proprietorships-partnerships/report-business-income-expenses/claiming-capital-cost-allowance/calculate-deduction-capital-cost-allowance.html

Capital Cost Allowance and Depreciation / Deferred Tax Example

Company Information for Example

- Asset purchased in year 1 for $100,000
- Management estimates 5 years useful life
- Company uses straight-line depreciation
- Income tax rate for the company is 50%
- For income tax purposes, Capital Cost Allowance (CCA) is 50%
  - First year CCA rule: can only use ½ rate (called the ½ rate rule)
  - CCA is a declining balance method
  - Accounting uses Net Book Value to show Acquisition Cost less Accumulated Depreciation (Balance Sheet presentation)
  - CRA used Undepreciated Capital Cost to show Capital Cost less Cumulative CCA

Income statements

These would be the statements in your accounting system

Item	Year 1 (Given)	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Revenues	$300,000	$300,000	$300,000	$300,000	$300,000	$300,000	$300,000
Cost of Sales	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000
Gross Profit	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000
Operating Costs	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000
Income before Depreciation & Taxes	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Depreciation	$20,000	$20,000	$20,000	$20,000	$20,000	$0	$0
Profit before Tax	$80,000	$80,000	$80,000	$80,000	$80,000	$100,000	$100,000
Income Tax @ 50%	$40,000	$40,000	$40,000	$40,000	$40,000	$50,000	$50,000
Net Income After Tax	$40,000	$40,000	$40,000	$40,000	$40,000	$50,000	$50,000

Income statements
How Net Book Value would show on Balance Sheet

Item	Year 1 (Given)	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Revenues	*$300,000*	*$300,000*	*$300,000*	*$300,000*	*$300,000*	*$300,000*	*$300,000*
Cost of Sales	*$150,000*	*$150,000*	*$150,000*	*$150,000*	*$150,000*	*$150,000*	*$150,000*
Gross Profit	*$150,000*	*$150,000*	*$150,000*	*$150,000*	*$150,000*	*$150,000*	*$150,000*
Operating Costs	*$50,000*	*$50,000*	*$50,000*	*$50,000*	*$50,000*	*$50,000*	*$50,000*
Income before Depreciation & Taxes	*$100,000*	*$100,000*	*$100,000*	*$100,000*	*$100,000*	*$100,000*	*$100,000*
Depreciation	$20,000	$20,000	$20,000	$20,000	$20,000	$0	$0
Asset (Acquisition)	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Acc. Depreciation	($20,000)	($40,000)	($60,000)	($80,000)	($100,000)	($100,000)	($100,000)
Net Book Value (End of Year)	$80,000	$60,000	$40,000	$20,000	$0	$0	$0

Income Tax Expense

- There are two sets of 'books' required:
  1. Your Accounting System (ASPE / IFRS), and
  2. CRA – The information transferred to the GIFI (General Index of Financial Information) and filed with your annual tax returns.
- The Income Tax Act (ITA) does not allow depreciation expense as a deduction from Net Income
  - CRA allows for a Capital Cost Allowance and these figures are based on what Class your asset belongs.
  - Classes are defined such as:
    - ✓ Class 1 (4%) Building
    - ✓ Class 8 (20%) Furniture & Appliances
    - ✓ Class 10 (30%) computer hardware and systems software for that equipment
    - ✓ Class 10 also includes passenger vehicles (Class 10.1 if vehicle cost more than $30,000)
    - ✓ Etc
  - These change all the time

Income Tax Expense calculation

- To calculate Net Income for Tax purposes, disallowable expenses need to be added back in.
- To arrive at Net Income for Tax purposes, an allowance for capital costs is taken.
- In our example:
  - The profit before tax of $80,000 will need:
    - ✓ Add back the depreciation expense of $20,000
    - ✓ Determine the Income for Tax purposes of **$100,000**
  - Determine the CCA rate for the Class = 50% (given)
  - For the year of acquisition, only ½ of the CCA can be claimed
  - $100,000 x 50%CCA x ½(1st year) = **$25,000 CCA**
  - Net Income for Tax Purposes = $100,000 - $25,000 = $75,000
  - Income Tax expense (for CRA) is $75,000 x 50% = $37,500

Item	Year 1	
Revenues	$300,000	
Cost of Sales	$150,000	
Gross Profit	$150,000	
Operating Costs	$50,000	
Income before Depreciation & Taxes	$100,000	
Depreciation	$20,000	
Profit before Tax	$80,000	
Income Tax @ 50%	$40,000	
Net Income After Tax	$40,000	

Income statements
Translated to show effects of **CCA** versus **Depreciation**

Item (S/L depreciation)	Year 1		Item (CRA)	Year 1	△ CRA / ASPE	
Revenues	$300,000		Revenues	$300,000	$0	
Cost of Sales	$150,000		Cost of Sales	$150,000	$0	
Gross Profit	$150,000		Gross Profit	$150,000	$0	
Operating Costs	$50,000		Operating Costs	$50,000	$0	
Income before Depreciation & Taxes	$100,000		Income before Depreciation & Taxes	$100,000	$0	
Depreciation S/L	**$20,000**		**CCA**	**$25,000**	$5,000	Increases allowable expense
Profit before Tax	$80,000		Profit before Tax	$75,000	$5,000	reduces before tax profit
Income Tax @ 50%	$40,000		Income Tax @ 50%	$37,500	$2,500	Reduces income tax expense
Net Income After Tax	$40,000		Net Income After Tax	$37,500	$2,500	Reduces net income after tax

Add back the $20,000
Deduct CCA of $25,000

Concept of deferred taxes

- There will be two (2) forms of taxes payable shown on the Balance Sheet
  1. The accounting income taxes payable based on the net income using your straight line depreciation expense, and
  2. The CRA Income Taxes Payable based on the your tax filings which use the Capital Cost Allowance
- The true payable is the amount liable to the CRA whereas, the other amount is a “paper difference” which will be accounted for and deferred for later use.
- In our example, the Net Income was higher using depreciation versus CCA ($80K versus $75K respectively) and that means $5K of income will need to be taxed at a later date, and taxes paid on that income
- Hence the ‘Deferred Income Tax’ or ‘Future Income Taxes Payable’.

Accounting for Deferred Taxes

- If your accounting Net Income is different than Net Income for Tax Purposes, the difference will be carried on the balance sheet.
- Example:
  - Accounting Net Income was $80,000 and we recorded a $40,000 Income Taxes Payable.
  - Net Income for Tax Purposes was $75,000 and the true liability for taxes is $37,500.
  - The difference of $2,500 is carried on the balance sheet as a liability of $2,500 for future taxes payable.

Account	Debit	Credit	Memo
Income Tax Expense	$40,000		Record tax expense
CRA Taxes Payable		$37,500	Record CRA payable
Deferred Income Tax		$2,500	Record payable deferred

Income statements from Table 2.5, page 64
These would be the statements in your accounting system (column 3)

Item	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Revenues	$300,000	$300,000	$300,000	$300,000	$300,000	$300,000	$300,000
Cost of Sales	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000
Gross Profit	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000
Operating Costs	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000
Income before Depreciation & Taxes	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Depreciation	$20,000	$20,000	$20,000	$20,000	$20,000	$0	$0
Profit before Tax	$80,000	$80,000	$80,000	$80,000	$80,000	$100,000	$100,000
Income Tax @ 50%	$40,000	$40,000	$40,000	$40,000	$40,000	$50,000	$50,000
Net Income After Tax	$40,000	$40,000	$40,000	$40,000	$40,000	$50,000	$50,000

For the Tax and Balance Sheet impacts for the following years, lets start with the Profit Before Tax Line

Calculating Net Income for Tax Purposes

Item	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Profit before Tax	$80,000	$80,000	$80,000	$80,000	$80,000	$100,000	$100,000
(1) Income Tax (50%)	$40,000	$40,000	$40,000	$40,000	$40,000	$50,000	$50,000
Add back dep'n	$20,000	$20,000	$20,000	$20,000	$20,000		
Profit bf Tax & Dep'n	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Deduct CCA (50%)	$25,000	$37,500	$18,750	$9,375	$4,688	$2,344	$1,172
Net Income for Tax	$75,000	$62,500	$81,250	$90,625	$95,313	$97,656	$98,828
(2) CRA Tax (50%)	$37,500	$31,250	$40,625	$45,313	$47,656	$48,828	$49,414
Tax deferred **(1)** – **(2)**	$2,500	$8,750	($625)	($5,313)	($7,656)	$1,172	$586
Cum tax def. Dr / (Cr)	($2,500)	($11,250)	($10,625)	($5,313)	$2,344	$1,172	$586
Net Book Value (EoY)	$80,000	$60,000	$40,000	$20,000	$0	$0	$0
UCC (EoY)	$75,000	$37,500	$18,750	$9,375	$4,688	$2,344	$1,172

Summary – Deferred Tax

- Accounting taxes payable is different than CRA taxes payable
- Differences are carried on the balance sheet. Deferred Taxes:
  - is a credit balance or a liability when accounting income is higher than taxable income

Account	Debit	Credit	Memo
Income Tax Expense	$40,000		Record tax expense
CRA Taxes Payable		$37,500	Record CRA payable
Deferred Income Tax		$2,500	Record taxes deferred

  - Is a debit balance or an asset when accounting income is lower than taxable income

Account	Debit	Credit	Memo
Income Tax Expense	$40,000		Record tax expense
CRA Taxes Payable		$45,313	Record CRA payable
Deferred Income Tax	$5,313		Record taxes deferred

Summary Tax Deferrals

	ACCOUNTING SYSTEM	CRA Tax Preparation	INCOME STATEMENT (PUBLISHED)	NOTES:
REVENUE	$300,000	$300,000	$300,000	
COST of SALE	($150,000)	($150,000)	($150,000)	
GROSS PROFIT	**$150,000**	**$150,000**	**$150,000**	
OPERATING EXPENSES	($50,000)	($50,000)	($50,000)	
DEPRECIATION	($20,000)		($20,000)	Depreciation not allowed for Tax purposes
CCA		($25,000)		CCA Tax purposes (Note the $5,000 difference)
TOTAL COSTS	**($70,000)**	**($75,000)**	**($70,000)**	Note higher total costs for tax purposes due to CCA
PROFIT BEFORE TAXES	$80,000	$75,000	$80,000	Higher CCA translates to lower Income for Tax Purposes
CURRENT TAXES	($40,000)	($37,500)	($37,500)	Lower actual income tax owed to CRA versus accounting
DEFERRED TAXES		($2,500)	($2,500)	Difference between Accounting and CRA tax expense
PROFIT for YEAR	$40,000	$35,000	$40,000	Note the $5,000 difference in profit that will be dealt with in subsequent years

Note: The cumulative Tax Deferral or Future Income Taxes payable is held on the Balance Sheet:

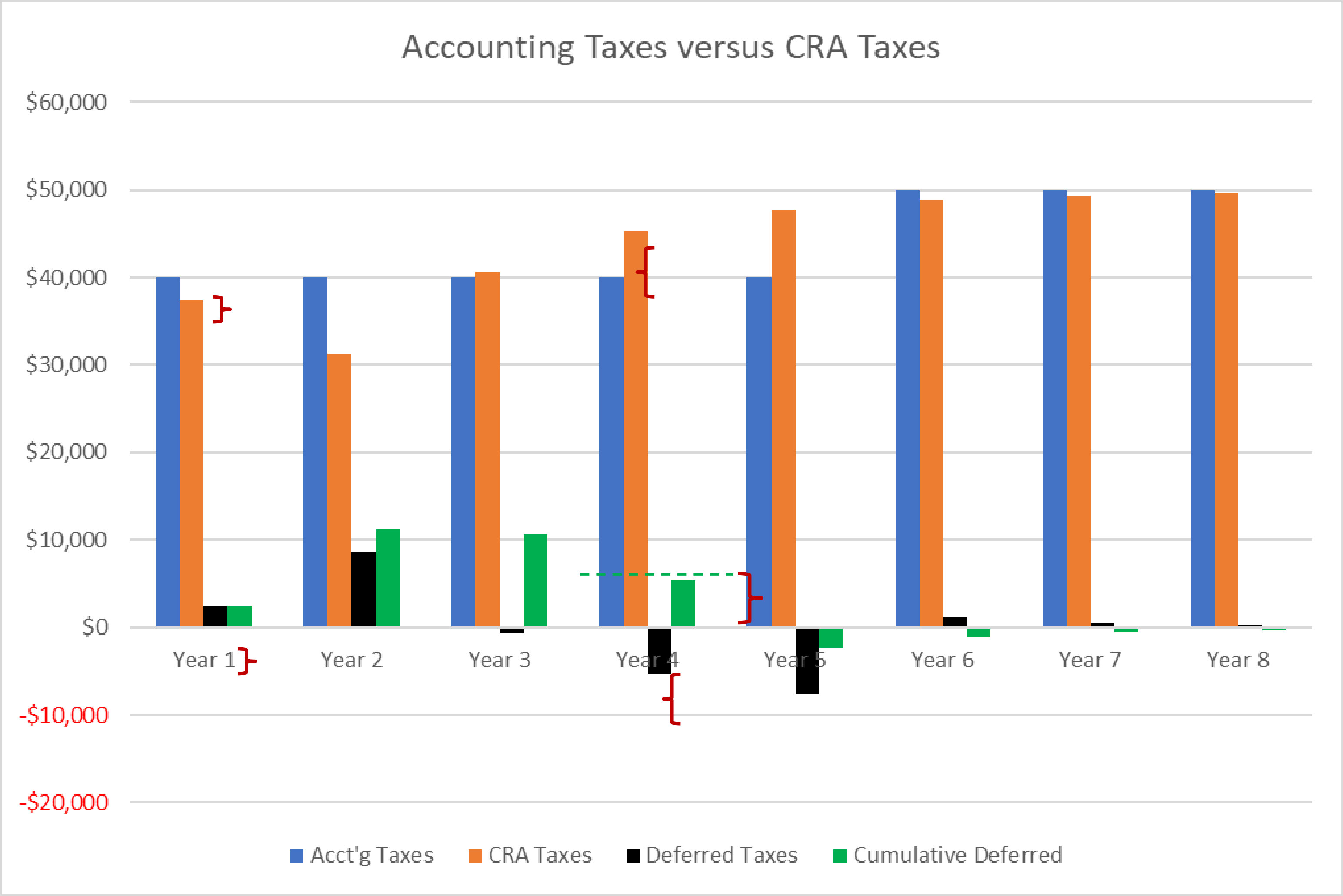
- As a credit (liability) when accounting tax expense is higher than CRA taxes – over expensing tax – ie: provide for future
- As a debit (asset) when accounting tax expense is less than CRA taxes – under expensing tax – ie: prepaying taxes

Summary Tax Deferrals

Note: The **Cumulative Tax Deferral** or **Future Income Taxes Payable** is held on the Balance Sheet:

- As a credit (liability) when accounting tax expense is higher than CRA taxes – ie: over expensing tax & provide for future taxes. Examples:
  - Amortise an asset over 5 years (high @ 20%) versus 10% CCA (Class 6 – Barn)
  - Lower CCA amounts (30%) versus amortization amounts (50%) (Class 10 Computers)
- As a debit (asset) when accounting tax expense is less than CRA taxes – under expensing tax – ie: prepaying taxes. Examples:
  - CRA offers tax incentives of 100% in year 1, versus amortization over years
  - Higher CCA amounts (say vehicles 30%) versus management estimate of useful life (say 7 years at 14.3%)

Deferred Taxes – graphical representation



Deferred Taxes are both an expense/recovery and an asset/liability

Acctg Tax = CRA +/- deferred

Accounting tax gets published with financial statements

Cumulative deferred tax held on balance sheet and amortized over the life of the asset or until zero (0).

Yr1

Acctg Income Tax	> CRA Income Tax	
	Debit	***Credit***
Income Tax expense	$40,000	
CRA Taxes		$37,500
Deferred Income Tax		$2,500
	$40,000	*$40,000*

Yr4

Acctg Income Tax	< CRA Income Tax	
	Debit	***Credit***
Income Tax expense	$40,000	
CRA Taxes		$45,313
Deferred Income Tax	$5,313	
	$45,313	*$45,313*

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