WWW.THINKPELORUS.CA

301-3700 Steeles Ave W, Vaughan ON L4L 8K8
Tel. 905 850 3330 Fax. 905 850 3329

CLARITY VISION RESULTS

Business Matters

VOLUME 26 | ISSUE 5 | OCTOBER 2012

TECHNOLOGY

Adiós XP...The Countdown Begins

If your computer runs on the Windows XP operating system, start preparing now for April 8, 2014, when Microsoft will stop providing support.

Time has crept up on us. As of April 8, 2014, Microsoft will no longer support its Windows XP operating system (OS), now more than a decade old. With the passing of this venerable system now imminent, it is time for you to find and install a new OS in your business. Computers will, of course, continue to boot up and run programs on XP after April 8, 2014; however, Microsoft will not provide support for the XP OS thereafter, which means no new security updates or patches will be released. It will be somewhat like having an old car: manufacturers no longer build the car and may not even make the parts, but you can still make the car run as long as you know how to repair, adapt and fabricate any parts you need.

At first blush those who use XP as an operating system may not be concerned about the discontinued support because the system will still work. But the dilemma of not moving to one of Microsoft's newer operating systems, such as Windows 7 or the upcoming Windows 8, is somewhat like the dilemma faced when the motor seizes in an old car. Is it worth the expense and hassle of fixing or is it more economical just to go out and buy a new one?

Security

After April 8, 2014, anyone using XP, whether for business or at home, will no longer receive updates and fixes. Although the pop-ups and mandatory restarts may occasionally be annoying, those patches are helping to keep the system safe by repairing vulnerabilities that can be exploited by a malicious attacker.

Once Microsoft stops offering updates for XP, security will become more of an issue.

Once Microsoft stops offering updates, security will become more of an issue. Software vendors may attempt to fill the void for a time with third-party security products, for a price, although third-party software may not be able to plug holes discovered in the underlying OS. Ideally, both the OS and anti-virus or security software should be kept up to date, as they serve different purposes.

Moving Away from XP

Security aside, it is also important to note that new software may no longer support Windows XP. Approximately half of desktop and laptop computers now use Windows 7; about one quarter are still using Windows XP, although that number is continuing to drop each month. (The balance includes Windows Vista, Mac OS X, Unix, Linux and others.) Publishers may elect to use features in newer versions of Windows that may preclude compatibility with XP, or make it more difficult. Now that a majority of computers are running operating systems other than XP, fewer publishers will go to the trouble and expense of ensuring compatibility for what is on the way to becoming a niche market.

Migrating to a New OS

The full impact of migrating really depends on the age of your current computers and software applications. Old computers may not run Windows 7 or 8 adequately and may need to be replaced. Although Windows 7 has very good backwards-compatibility, you might find that not all older programs will run perfectly. For standard programs like the office suite, new versions optimized for Windows 7 are widely available.

If you have any old or custom software that doesn't work as expected in a newer version of Windows, the business editions of Windows 7 offer a downloadable add-on called "Windows XP mode," which is a virtual copy of Windows XP that runs in the background to support older applications. Windows 8 can achieve a similar result with a built-in virtual machine called Client Hyper-V. In a way, Client Hyper-V is a double-edged sword: it can support multiple 32- or 64-bit operating systems, including but not limited to Windows XP; however, a 64-bit processor and more configuration are required. Each operating system must be installed and set up as a virtual machine within Windows 8, as if it were being installed on its own machine.

Time-Consuming Data Transfers

Beyond the technical aspect of hardware and software changes, migration also involves the time-consuming process of backing up your files and transferring data. This may be simplified somewhat if most of your content is stored on a network location rather than the local PC, although the server may also need to be upgraded if it's on an old version of Windows Server. Windows NT Server and 2000 Server editions are already unsupported and should be upgraded as soon as possible; support for XP's server counterpart, Windows Server 2003, ends in July 2015 and should be included in your migration plan.

Management may wish to consider holding onto some of the older computers with the older OS and applications for a while following the transfer in the event that data, functions or software are not fully compatible with the newer versions. Similarly, some specialized older hardware, such as a printer or modem, may be worth keeping for a business need, but may not have drivers or ports supported on the new systems.

Now Would Be a Good Time

Although the time needed for the physical transition to new computers and the migration of data and application programs may be measured in days or weeks, depending upon the sophistication of the application, the actual understanding and ultimate acceptance of an upgrade may take some time before all individuals using the new system feel comfortable with it. Therefore, if one works back from April 8, 2014, to today (October 2012) it is startling to discover that only about 18 months remain until Microsoft ends support for Windows XP. In order to meet this challenge, you need to start conversion planning right now to ensure that when Microsoft says "Lights out!" your business will not be caught without OS support and OS updates. You do not want to find that your business cannot move forward because your operating system does not function properly, your electronic records are at risk of being hacked or data is no longer accessible to your own employees.

MANAGEMENT

When the Owner-Manager Can't Be There

An owner-manager's sudden illness or tragic accident can be devastating to the business.

Being prepared for the unexpected long-term absence of the owner-manager means having a plan. Every owner-manager should have a list of issues that need to be in order at any given moment in case they can't be there to manage the business.

The Chain of Command

Who will take over during the convalescence of an owner-manager? This is the time when a good succession plan clicks into place even though the person being succeeded is expected to return. It is a time when the designated successor is tested. In situations where one or more owner-manager's spouse works for the company, a pre-planned temporary succession should prevent concern over control or domination by any one owner in the absence of the other. An acceptance by all owner-managers before the event avoids infighting and the loss of productivity and direction.

Remuneration While Incapacitated

Owner-managers should have a written agreement that stipulates the remuneration to be paid when one of the owners is incapacitated. The incapacitated owner is obviously not contributing to revenue but still needs funds to meet family living expenses. Setting up payment guidelines allows the company to know what it must pay out and the incapacitated owner-manager to know what income to expect.

Inform Staff

Staff should be immediately informed of the seriousness of an owner-manager's condition and any anticipated prolonged absence. Everyone should be fully briefed to prevent the anxiety and insecurity that creates rumours. Employees should know it is business as usual and should be told who will now be their go-to person. Changes based on the succession plan for the chain of command should be implemented immediately.

List of Major Suppliers

Contact persons at major suppliers should be called immediately, informed that Mr. X is temporarily indisposed, assured that business will continue as usual, and provided with the name of the new contact person. This call will indicate to the supplier the importance of their place in your operations and create some forgiveness if orders or payments are delayed or incorrect.

List of Major Clients

A list of contacts at major clients is also a good idea. Let them know that it is business as usual and give them the name of the new person to whom they should talk about products, services or invoicing. By contacting the client you will both eliminate the client's fears that the supply of goods or services will be interrupted by the absence of their usual contact, and also lessen the risk that the client will migrate to the competition.

Tell staff right away about the owner-manager's condition before the rumours start.

Review Health and Disability Insurance

When premium notices are received, policies should be reviewed to ensure coverage of key personnel is adequate for accident or health benefits in addition to death benefits. Any inadequacies in the coverage should be fixed at this time. It is also a good time to review the benefits provided in case of illness, and the tax impact of those benefits on the recipient. Understanding the policy and payout schedule will also help determine remuneration that may be paid in the short or long term.

Power of Attorney/Signing Authority

Many owner-managed businesses may have only one person authorized to sign cheques and important documents. Such limited authority can lead to banking or processing problems in the event that individual is incapacitated or suddenly deceased. It is prudent to have at least three individuals empowered to sign cheques, authorize payments or negotiate loans.

Access Codes

Many owner-managers do not know important passwords. Passwords for all systems, as well as the combination to the in-house safe, should be provided to other key owners or stored in a secure place and available to authorized personnel in an emergency. Senior management's control over these areas ensures that business continues as usual, provides uninterrupted management of all sensitive financial and operational areas, and heads off the potential for opportunistic fraud by individuals taking advantage of the confusion that can accompany tragedy.

Shareholder Agreement

A signed and dated shareholder agreement is the most important document shareholders can have. A properly worded shareholder agreement determines the meaning of disability, voting rights, restrictions on transfer of shares, assignment of shares in the event of death or incapacity, right of first refusal, valuation, and a myriad of other issues that protect the company and owner-managers from actions that could destroy the company.

Shareholder Draw Accounts

All shareholder accounts should be up to date so that those left in charge can project remuneration for the incapacitated owner-manager and therefore assist family members in understanding any potential tax liability. This in turn can have an impact on the timing of any sale of shares or dividend payout while the owner-manager is absent and not withdrawing funds or receiving a bonus.

Lending Agreements, Contracts

A list of lending agreements and contracts with pertinent details of interest rates, collateral, due dates, caveats, and monthly pay amounts should be immediately available to the successor of the incapacitated owner-manager.

Such a list provides an understanding of cash flow requirements in addition to operating requirements. This knowledge, combined with a review of the in-house financial records of accounts payable, accounts receivable and bank balances, helps minimize a cash crunch.

Shareholders may wish to reassess the impact on the estate, the company, and on other shareholders of any corporate loans attached to the personal guarantee of the absent owner-manager that may be subject to call.

The Business Must Go On

Recovery from personal illness or an unfortunate accident can take days or months. Business can survive a few days without guidance or direction, but after that confusion and uncertainty set in and start to erode the confidence of management, employees, clients and suppliers. Completing and updating a list of key areas within your business eliminates confusion and ensures that the injured party comes back to a "business as usual" environment.

MONEYSAVER

Sins of Omission

Losing sight of the most basic issues can cause trouble to the bottom line.

Owner-managers are a special breed. They have tenacity, optimism and a strong belief in their own ability to succeed. Success, however, is the result of making the right decisions day after day. It should, therefore, not be surprising that inattention to basic activities can often create problems. The following list may help owner-managers avoid some common problems.

1. Not reviewing basic financial data

Many owner-managers do not get the maximum value from the basic financial data produced by their accounting department; the focus is usually just on accounts receivable, accounts payable and payroll. The financial data gathered through the humble bookkeeping process provides insight into patterns in cash flow, sales revenue, payroll costs, job costing and the like on a day-to-day basis, i.e., before they are brought together in the financial statements. Tracking this data at the ledger and trial-balance level will reveal the small beginnings of unhealthy trends before they become big problems.

2. Not paying taxes on time

When cash flow is tight there is a tendency to redirect funds collected for remittance to various tax authorities. Failure to remit payroll withholding taxes, HST/GST/PST, or income taxes can result in penalties by regulators. Management should review the weekly bank balance in the general ledger as well as the aggregate of amounts of tax due for remittance. Bookkeepers should ensure sufficient funds for remitting the withholding taxes are *always* in the bank account.

3. Not reviewing accounts receivable

The ability to survive depends on cash flow. Normal business practice used to be to pay invoices in 30 days; now, 60-to-90 days is the norm. But 90-day collection creates a number of financial concerns. First, HST/GST may have to be remitted even though the funds have not been collected. Second, you are financing your accounts receivable for longer. Third, if credit is tight and suppliers are not willing to grant you additional credit, the lack of cash will affect inventory levels, production and sales.

Regular review of accounts receivable will show how many clients are now extending payment terms or asking for higher credit limits. By regularly monitoring the tightening credit terms of suppliers and the demands for better terms by customers, the alert owner/manager will be aware early that a cash flow problem may be building.

4. Failure to control draws

Taxes are not withheld when sole proprietors make withdrawals from the business. As a result, the sole proprietor may be surprised at the end of the calendar year when a hefty personal income tax payment plus CPP contribution may be required. Additional withdrawals to pay income tax will create additional taxable income for the sole proprietor and could create working-capital difficulties for the business.

Not monitoring draws taken from your company can be the kiss of death. In many instances, owner-managers take draws instead of a regular wage (in which the usual deductions are withheld and remitted to the Canada Revenue Agency (CRA)). Salary or wage-based compensation provides the owner assurances that personal tax liability will be covered, (assuming this is the only source of taxable income) as well as providing a guideline for determining the RRSP-contribution level in the year following. Further, it allows management to assess the impact of its own remuneration on the company's bottom line.

5. Taking on too much debt

Cash flow requirements should be analyzed before taking on debt to enlarge the premises, purchase additional vehicles, or expand into new territory. Financial data should be mined to compare historical monthly cash flows with projected receipts and disbursements. This exercise also permits management to determine whether the projected debt and repayment structure is supported by historical norms.

6. Not understanding financial statements

Without understanding financial statements you cannot really understand how your business is doing. Financial statements, whether created by monthly bookkeeping or provided by your chartered accountant at the end of the year, are indicators of the well-being of your company. In order for managers to make financial information more useful to themselves and to their creditors, in-house statements should resemble year-end statements as closely as possible. To do so your accountant may be required to "tweak" internal statements with proper allocation, headings, subheadings and final totals.

A monthly summary of financial data in financial statement format will show a true picture of assets, liabilities, owners' equity and profit and loss for the period. When compared with previous years or the previous month, such data can alert you to problems or opportunities.

7. Failure to invest in the future

When times are good owner-managers tend to withdraw more money for themselves. However, paying yourself should be balanced against the impact withdrawals have on working capital and the company's future.

Before taking rewards, management should do some projections based on market trends, client base, capital asset requirements, the cost of financing, operational and payroll costs, potential for growth, changes in demographics, and changes in technology. Examination of these key areas will enable management to assign costs and benefits and determine working capital requirements to move forward.

Hiring a consultant to review your business may be a good investment.

8. Failure to understand your market

Your product may be excellent, your service exemplary and your price right, but, when your product becomes stodgy, your company may be headed for a fall. Attend trade meetings, read trade magazines and talk to your clients and suppliers to find out what is new in your market. Hiring a marketing consultant to review your business and where it should be going may be a good investment.

9. Not preparing cash flow and profit forecast

Forecasting cash flows and profits forces owner-managers to think about future available funds, revenues, expenses and capital spending. These forecasts may bring up issues of working capital needs, potential long-term debt requirements or even issues concerning staffing or the need for larger floor space.

10. Not involving specialists

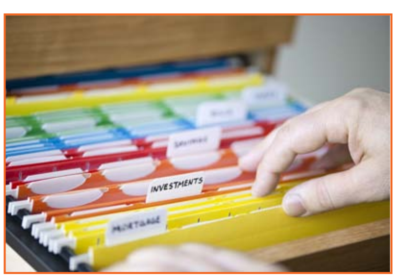
The single biggest weakness of owner-managers is that they tend to make important decisions without seeking the advice of experts. The problems that may be created when decisions are made outside your area of expertise can be far more expensive than the cost of hiring consultants. Because they look at so many businesses, consultants often have knowledge beyond that of even the most talented owner-manager. Consultants are not hired to change your mind, but they can make you aware of your options and can provide valuable assistance when your business needs guidance into the future.

TAXATION

1994

If your personal investment portfolio holds assets purchased before 1994, make sure you still have a record of the purchase price.

Holding the same assets in a personal investment portfolio for more than 15 years is unusual given all the factors that change asset values over time. Nevertheless, some investors regard certain of their stock, real estate or other assets as core holdings and keep them for as long as 30 years or more. No matter how long you hold the investment, you need to have a record of the purchase and sale prices in order to calculate the capital gain or loss. If you purchased the investment before 1994, it is especially important to know both the purchase price and the price in 1994.



So, if you still hold investments purchased before 1994, it is time to ensure the requisite information for calculating capital gains or losses is available.

Retro Review

In 1985 the federal government introduced a lifetime capital gains exemption of $100,000 for all taxpayers. This allowed investors to make capital gains of up to $100,000 in their lifetime without paying a capital gains tax on any of it. Unfortunately, the exemption was abused by some investors, especially some involved in real estate transactions, who purchased property and flipped it for a quick capital gain on which the first $100,000 was deductible provided the exemption had not been applied against other investments. In 1992 the exemption for real estate transactions was terminated. The $100,000 lifetime exemption was eliminated for everyone effective February 22, 1994, (an exception applied to small businesses and farming operations). To soften the blow, the government allowed the taxpayer to file an election to place a value on existing capital assets as of that date. The increases in value over the original purchase costs were then exempt from the first $100,000 of capital gains.

The $100,000 lifetime exemption was eliminated effective February 22, 1994.

The Mechanics of Exemption

To show how the exemption works, let's look at some sample situations.

Scenario One: Assume an individual purchased shares in a public company in 1989 for $100,000 and the value of the shares skyrocketed to $210,000 by February 22, 1994. Since the rules allowed the taxpayer to elect any amount between cost on the low end and fair market value on the high end, the prudent taxpayer would have elected a value of $200,000 for a gain of $100,000 and then claimed the capital gains deduction of $100,000. The result would have been no capital gains tax payable in 1994 on the remaining $10,000 capital gain since the shares were not actually sold. Any potential tax liability would be deferred until the year of sale.

Scenario Two: Let's now assume the shares continued to be held until sold in 2012 for $300,000. Because the individual elected a value of $200,000 in 1994, a capital gain of $100,000 ($300,000 minus $200,000) is recorded for 2012. Since only half of the capital gain is taxable under current tax law, the taxpayer includes only $50,000 (50% of the $100,000 capital gain), rather than 50% of $200,000 ($300,000 less the $100,000 cost) in 2012 taxable income.

Scenario Three: Now, imagine that everything is the same as outlined in Scenario One up to the election of the $200,000 value in 1994, but that the market value has declined in the last 18 years and the shares were sold in 2012 for $180,000. The taxpayer now has a capital loss of $20,000 ($200,000 minus $180,000) that can be applied against any capital gains on the sale of other assets in tax year 2012.

Lack of Documents

Unfortunately, the purchase confirmations or monthly statements from brokerage houses for assets owned at February 22, 1994, may have gone astray in personal files by now. These documents may not, therefore, be available to establish the original purchase price, the February 22, 1994, valuation or any capital gain or loss that has occurred in the meantime. Imagine the tax impact using Scenario Two and Scenario Three above if the taxpayer cannot provide the tax preparer with the 1994 valuation. In Scenario Two, the taxpayer would have a capital gain of $200,000 ($300,000 selling price less $100,000 original cost) and, in Scenario Three, instead of having a $20,000 capital loss applicable to reduce other capital gains in 2012, the taxpayer would have a capital gain of $80,000 ($180,000 selling price less $100,000 original cost).

It should be noted that taxpayers can, via the Internet, access information from their T1 tax returns back beyond 1990 from Canada Revenue Agency's data base. This can be very helpful when trying to build one's history.

Unreported Sales

In 1994 many individuals claimed capital gains exemptions on a wide range of capital items from works of art to vintage automobiles. Undoubtedly many of those items have subsequently been sold without the sale having been reported to the Canada Revenue Agency (CRA) simply because the individual has forgotten or did not know the election had been made. This may not have created an issue while the taxpayer was alive but, when the taxpayer passes, it is likely that CRA's data base will retrieve these items and the estate may be asked to account for them. If these items have been sold, the CRA could request the tax on the capital gain and, possibly, interest on the unpaid tax from the date of sale.

Clearance Certificate

It may be a safe assumption that the majority of individuals have not retained their 1994 tax return and the election filed. Thus, there is always the possibility, especially when a taxpayer passes, that the estate may be valued for assets the executors were not aware had been sold. If records have not been maintained the estate is in the unenviable position of having to accept the CRA's assessment. For this reason, executors of the estate should ensure funds are held back for the possibility of an unforeseen tax levy. More importantly, once the final return has been assessed by the CRA, the executors should apply for a Clearance Certificate from the CRA that, once issued, ensures the CRA cannot assess additional tax against the estate. Your chartered accountant will be pleased to assist you in fulfilling the requirements of Form TX19, Asking for a Clearance Certificate.

BUSINESS MATTERS is prepared bimonthly by The Canadian Institute of Chartered Accountants for the clients of its members.

Richard Fulcher, CA – Author; Patricia Adamson, M.A., M.I.St. – CICA Editor.