PROFIT PLANNING OR: MANAGEMENT ACCOUNTING (Part II)

by
Murray Rumack, FCA, MIMC

(The following is the second and concluding portion of a two-part series which represents an address given by Mr. Rumack, a principal in the Toronto chartered accountants' firm, Murray Rumack, Stern & Cohen, to the Association's annual meeting at Windsor, on February 12, 1970.)

Budgeting and Forecasting

Along with the break-even point concept goes the item of budgeting and forecasting. No one would consider a contractor a wise man if he started to build any structure without blueprints and plans. (See figures 5A & 5B).

Similarly, you can understand that one would have little respect for any business or professional man who operates his business without a budget (or financial blueprint).

Budgets are merely forecasts of financial objectives allocated in such a manner as a business can within reason, determine how much money it is going to invest; how much it is going to realize by various sales or services to be rendered; what the cost will be to render these services; how much the overhead will cost, what will be left for the firm and how it will be used.

Figure 5A

Figure 5A indicates what a cash plan or budget might look like prepared on a month to month and quarterly basis. The chart can of course, be varied to suit the needs of any business and like the other charts is only offered as a suggested outline. This chart deals strictly on a cash basis for both operational as well as non-operational cash transactions.

Figure 5B

Figure 5B deals with a forecast of a financial structure from an operational point of view. This indicates that the budget can be compared with the actual results and the differences highlighted (where applicable). Management should and can closely observe the causes and the differences and take the necessary action to improve the situation if required.

When a monthly cash statement is compiled in a manner referred to above and compared with the cash budget, any variation of a material nature should be immediately investigated and where possible remedial action taken at once.

A budget and operating forecast and projected cash flow, in conjunction with a break-even point are among the most vital tools for modern management requirements. What is more, these are excellent items for use in presenting a plan which will indicate to a bank **why** one will require financing, **what** he will do with it, and **how** it is expected to be repaid. Needless to say, these forecasts should then be compared with the actual results monthly or quarterly. When conditions change materially, then of course, the forecasts of the various types listed above should be updated and revised in accordance with current experience and facts.

The benefit of the forecast is to have a true control of expenditures before the purchases or expenses are incurred. You should always know where you are going before a commitment is made and before it is too late.

The budget should be adjusted when events have made this unavoidable. **It is important to remember that the budget should be the servant of the manager, and not the manager the slave of the budget.**

"A Surveying and Engineering Company Limited" — Work-in-Process (See Figure 6)

Figure 6 may be considered to be a good form for keeping track of the work-in-process that a professional group such as an engineering or surveying company should have in its records and kept up to date at all times. This tells you at once in summary form, the job number, the customer name and all the vital statistics pertaining to the process and condition of that job.

"A Surveying and Engineering Company Limited" — Statement of Net Worth

Figure 7 shows a hypothetical case of how some professional groups measure their profit, such as "A Surveying and Engineering Company Limited". They prepare a statement of net worth on a comparative basis each month. By comparing the estimated net worth, before provision for taxes on a month to month basis, measuring the increase or decrease in net worth, rather quickly, but fairly accurately, tells them the profit or loss that they have realized or suffered as the case may be. In other words, this procedure helps management determine what the **real picture is, not just the cash picture.**

Incorporation

Now, of course, one has not only to make money, but to retain money. This still takes good planning. In spite of the Proposals on Changes in the Income Tax Act contained in the White Paper, a subject on which I may have some time to talk to you about a little later, I still say that you should take advantage of the legislation that has permitted members of your profession to incorporate. There are many facts to consider; one of them is the personal tax position of each partner. Subject to personal exemption of each partner, the guideline for income tax purposes is approximately $18,000 of taxable income per year. Up to this amount, it does really not pay to incorporate. However, even with the threat of the White Paper becoming law in January of 1972, I still urge you, under the above noted conditions to consider incorporating.

A firm of Chartered Accountants can readily explain to you the significance of carefully planning its client's income tax minimization program. Without elaborating because space does not permit, one should incorporate at approximately $18,000 of profits; leave profits at the lower rate of tax for the corporation on net profit up to $35,000; pay additional remuneration or bonuses to the owners on any extra amounts that the company earns until the owners reach approximate remuneration from salaries and directors' fees of about $90,000 each.

We should consider the fact that the increased rates of corporation taxes will only come about after a period of five years after implementation of the White Paper. Therefore, there is much to be benefited for same for several years yet.

Therefore, I suggest that we have approximately six years or longer to take advantage of the preferential rates, although we will not, it appears, be able to take full advantage for all six years, but some is better than none.

By incorporating, many of you will be able to properly engage the services of your wives who may do your secretarial work and have the corporation pay her a reasonable salary commensurate with the services that she renders. In this day and age when taxes are going higher and higher, it is incumbent on each of you to minimize taxation within the limits of the law. Accordingly, if your corporation hires your wife and she earns money, she will likely be paying income taxes on that money at a lower rate than if you were earning it personally. Of course,

(continued on page 15)

"A SURVEYING AND ENGINEERING COMPANY LIMITED"

Figure 5A

CASH BUDGET

YEAR ENDING 31 DECEMBER, 19.......

		$ January	$ February	$ March	$ First Quarter	$ Second Quarter
Cash Balance at Beginning of Period		1,000			1,000	
Estimated Receipts						
Collections on accounts receivable		25,000	25,000	27,000	77,000	78,000
Increase in bank loans		17,150			17,150	
Total		43,150	25,000	27,000	95,150	78,000
Estimated Disbursements						
Mortgages, liens, and interest thereon		7,100			7,100	
Expenses						
Sales commissions, etc.		1,250	1,250	1,250	3,750	3,750
Advertising			1,250	1,250	2,500	3,750
Delivery		850	850	850	2,550	2,550
Warehouse wages and supplies		1,000	1,000	1,000	3,000	3,000
Utilities			400	—	400	800
Taxes		600			600	600
Depreciation			no cash expenditure			
Insurance — warehouse, etc.		1,440			1,440	
Inventories		560			560	
Preparing and packaging		500	500	500	1,500	1,500
Bad debts written off			no cash expenditure			
Office and sundry		200	200	200	600	600
Interest		240	240	220	700	550
Withdrawals — living expenses		250	250	250	750	750
income tax				450	450	1,250
Repayment of restricted bank loans			5,000	5,000	10,000	3,500
Sub-total		13,990	10,940	10,970	35,900	22,600
Accounts payable, 31 December 19........	30,000	29,160	840		30,000	
Purchases — January	16,000		13,220	2,780	16,000	
February	16,000			13,250	13,250	2,750
March	16,000					16,000
Second Quarter	48,000					32,000
Second Half	96,000					
Repayment of demand bank loans						2,000
Other loans						2,500
Total		43,150	25,000	27,000	95,150	77,850
Cash balance at close of period		—	—	—	—	150

(continued from page 13)

what really hurts is that she has been working, and you have not been able to pay her and deduct same and you are paying income taxes at a higher rate than you should be because her earnings are not tax deductible prior to incorporating.

In a corporation, as your wife will now be a regular employee, you will be able to pay her reasonably well to even cover the annual amounts provided in the White Paper of $500.00 per child under 14 years of age (maximum $2,000 per family) for nurseries, etc. that your wife may have to send your children to, in order that she may work for you. This too, comes out at a high tax level which effectively costs you about one-half.

Furthermore, you and your wife should now be able to be covered in a proper pension plan of which the company will pay for up to $1,500 per person per year and therefore you invite the government to be your partner in paying for same. This is a new twist in not giving to the government.

You are advised to consider the goodwill factor if you incorporate and to obtain a figure for goodwill where applicable.

Certainly, you should obtain the services of independent appraisers to help you determine the value of goodwill. This appraisal may be very helpful to you if your company is challenged by the Department of National Revenue to establish the basis of a calculation for same. The proceeds from establishing goodwill may later be realized at a much lower rate of income tax.

I am sure that you understand that once goodwill is established and the amount is agreed upon by the Department of National Revenue, that this still leaves a sum that can someday be withdrawn relatively free of any further taxation, although you will have to earn the tax paid dollars to have the cash available to withdraw for the payment of goodwill. I am of the opinion that you are never going to have an opportunity again if the White Paper comes into force to take out money as comparatively cheap as you have now. Therefore act now! However, goodwill on the books may have a disadvantage too!

In the event of death, your executors should be prepared to establish that goodwill was only good while you were alive, especially in a professional firm.

Those of you who are working for corporations which do not have company sponsored pension plans (or where you do not contribute up to $1,500 if there is a pension plan), should seriously consider (if you have not already done so) minimizing your taxable income by investing in one of the many types of plans that are available under the general heading of Registered Retirement Savings Plans.

You are permitted to contribute up to the lesser of 20% of your income (or $2,500) which is the maximum. Where you are not receiving the benefits of a company paying into a pension plan, this amount holds **true.** Otherwise, $1,500 is the maximum that may be contributed by you to either or both a pension plan or Registered Retirement Savings Plan. This is an amount that is applicable annually. If you are doing your arithmetic, you will see that the government is helping to pay for it!

Estate Planning

Estate planning is **not** a plan for after death by itself by any means; on the contrary, it is a plan devised during your life-

(continued on page 17)

"A SURVEYING AND ENGINEERING COMPANY LIMITED" **Figure 5B**

PROFIT AND LOSS STATEMENT

SIX MONTHS ENDED 30 JUNE, 19........

	Actual Total $	%	Operating Budget $	Difference $
Gross sales	162,500			
Less returns	2,500			
Net sales	160,000	100.0		
Opening inventory	37,000			
Purchases	91,500			
	128,500			
Closing inventory	27,500			
	101,000	63.1		
Gross Profit	59,000	36.9		
Selling and Handling Expenses				
Sales commissions and expenses	8,000	5.0		
Advertising	7,500	4.7		
Delivery	5,800	3.6		
Warehouse wages and supplies	6,000	3.8		
Utilities and heat	1,200	.7		
Taxes	600	.4		
Depreciation	1,500	.9		
Insurance	515	.3		
Preparation and packaging	6,000	3.8		
Repairs to equipment	1,600	1.0		
Repairs to building	800	.5		
Bad debts written off	1,000	.6		
	40,515	25.3		
Contribution to Net Profit (Loss)	18,485	11.6		
General Expense	1,600	1.0		
Office and sundry	1,485	.9		
Interest	3,085	1.0		
Net Profit	15,400	9.7		

(continued from page 15)

time, for your lifetime, as well as for after your lifetime.

When one considers that an estate of up to $300,000 now pays federal estate taxes of almost $90,000 and 50% on any amount higher than that, then it certainly behooves you to start planning to minimize this type of confiscation of capital by our governments!

You may now give to your spouse any unlimited amounts during your lifetime and after your lifetime. These gifts are **not** subject to gift taxes nor to estate taxes, provided that they are transfers between spouses.

In addition, you are permitted to give annually an amount of up to $2,000 per child or to anyone else without attracting any gift taxes. Therefore, if one has a new-born child and gives $2,000 for each of the ensuing 18 years to that child, at the end of 18 years that child will have accumulated (without compounding any interest) $36,000. At age 19, when the child starts to pay income taxes on that income, the child will likely pay income taxes at a lower rate than the rate you would be paying if you would have retained all that capital. (However, up to the age of 19 the donor parent pays the taxes on earnings of these gifts although the money belongs to the child.)

Therefore, one can send a child to university for example at much lower tax-paid dollars than you could if you had retained that capital, what is more, you have divested yourself of a great deal of capital that would otherwise have been left in your hands and potentially subjected to estate and succession duties.

Similarly, your wife who may receive gifts from you, or may earn money independently, may give similar amounts to the children or anyone else within the limits indicated above without attracting gift taxes as well. Therefore, this $36,000 can become $72,000 per child! In addition, there are many other new areas that have been opened up as well as closed under the new Estate Tax Act. Space limitations permit only a minor reference to this situation, but you are cautioned to engage competent accountants and lawyers to help you plan your affairs in such a manner as you and your estate will have to pay a minimum of gift taxes as well as estate taxes.

Keep in mind that to minimize estate taxes, when you and a lawyer draw a Will, you should specifically bequest an amount of $10,000 per child, in order to obtain that exemption of $10,000 per child. If you do not name this specific bequest of that amount per child, the exemption does not count for estate tax purposes. You should also be aware of the fact that where any of you have children under the age of 26, that in addition to the amount of $10,000 per child, one's estate has an additional exemption of $1,000 per child for every year that that child is under the age of 26.

These are some of the "tools" that may be used in Profit Planning. The more you employ them, the more profitable (and less frustrating) will be your business. Start to use them NOW!

Questions were taken up from the floor and answers given.

WHAT KIND OF MEMBER ARE YOU?

Some are like wheelbarrows — No good unless pushed. Some are like trailers — they have to be pulled. Some are like kites — If you don't keep a string on them they fly away. Some are like balloons — full of wind and ready to blow up. Some are like footballs — you can't tell which way they will bounce — And then, some are like a good watch — Open face, pure gold, quietly busy, and full of good works.

Figure 6

"A SURVEYING AND ENGINEERING COMPANY LIMITED"

WORK IN PROCESS

AS AT MAY 31, 1970

Job #	Customer	1 Estimated Hours Original	2 Estimated Hours Current	3 Hours Used To Date	4 Eng. & O.H. Hourly Rate	5 Eng. & O.H. to Date	6 Total Eng. & O.H.	7 Mat'l Costs to Date	8 Accrued Mat'l Costs	9 Work-in-Process	10 Percent Eng. Complete	11 Total Contract Price	12 Total Contract Costs	13 Est'd. Total Profit Current	14 Est'd. Total Profit Original	15 Est'd. Earned Profit	16 Progress Billing
						(3 x 4)	(2 x 4)			(5 + 7)	(3/2 x 100)		(6 + 7 + 8)	(11 — 12)		(10 x 13)	
69-391	Name	500	600	400	10.00	4,000	6,000	10,000	5,000	14,000	66%	25,000	21,000	4,000	5,000	2,650	12,000
69-392	Name	30	30	25	10.00	250	300	2,200	800	2,450	83%	4,100	3,300	800	800	665	3,000

Figure 7

"A SURVEYING AND ENGINEERING COMPANY LIMITED"

STATEMENT OF NET WORTH

AS AT:	JANUARY 31		FEBRUARY 28		MARCH 31		APRIL 30	
Assets								
Cash — on hand	$ 200		$ 200		$ 200		$ 200	
— bank	6,000		8,000		—		1,000	
Accounts receivable	11,000		12,000		13,000		15,000	
Fees earned and unbilled (work in process)	2,000		3,000		4,000		3,000	
Goodwill	30,000		30,000		30,000		30,000	
Automobiles, cost less accumulated depreciation	4,000		4,000		4,000		4,000	
Equipment, cost less accumulated depreciation	6,000		6,000		6,000		6,000	
Other assets	1,000	$60,200	—	$63,200	1,000	$58,200	—	$59,200
Liabilities								
Bank indebtedness — overdraft	—		—		1,000		—	
— loan	5,000		5,000		—		—	
Accounts payable	3,000		4,000		2,500		4,000	
Salaries and wages accrued to month end	1,000		1,500		1,000		2,000	
Employees' payroll deductions payable	2,000		1,500		1,500		2,000	
Other liabilities	1,000	12,000	2,000	14,000	1,000	7,000	1,000	9,000
Estimated net worth before provision for taxes		$48,200		$49,200		$51,200		$50,200
Increase (decrease) in net worth								
— for the month				$ 1,000		$ 2,000		($ 1,000)
— for the year to date				$ 1,000		$ 3,000		$ 2,000