CHAPTER 8

FINANCIAL STATEMENTS

Learning Objectives

After studying this chapter, a student should be able to:

- ☑ List the different forms of business organization and discuss their legal rights and responsibilities
- ☑ Describe the generally accepted accounting principles on which financial statements are based
- ☑ Explain the purpose of and differences between a balance sheet, income statement, and income tax return
- ☑ Discuss how financial statements differ for the proprietorship, partnership, and corporate forms of business organization

INTRODUCTION

Up to this point, the topics covered in this course have mainly focused on legal issues related to real property, including the legal rights, responsibilities, and liabilities on individuals transacting in real property. In most situations, these transactions involve individuals acting in their own interests, but at times they may involve business entities that buy, sell, or lease real property. Different rules apply to various forms of business organizations and market participants may have strategic business reasons for their use.

In order to adequately represent a client's interests, licensees need an understanding of the principal forms of business ownership: the sole proprietorship, the partnership, and the corporation. These ownership models are distinguished by the degree that the business is a legal entity, separate from its principals or owners. The degree of legal separation between the owner and the business has direct implications for income tax liability, exposure (liability) to civil lawsuits, and a number of related provincial and federal requirements.

This chapter discusses the forms of business organization and various related accounting and financial reporting topics necessary for understanding their application.

FORMS OF ORGANIZATION

The three most common forms of business organizations are sole proprietorships, partnerships, and corporations.

Sole Proprietorship

A *sole proprietorship* is a business enterprise that is owned by a single individual. It is the simplest form of business organization and is the most common type of business enterprise in service industries.

sole proprietorship
a business enterprise owned by a single individual

One of the consequences of operating a proprietorship is that the owner is personally liable for all debts incurred by the proprietorship. If the proprietorship is unable to pay its debts, the proprietorship's creditors may collect from the personal assets of the owner. This is referred to as unlimited liability. A proprietorship is not regarded as a separate legal entity and does not pay income taxes. Instead, the profits of the proprietorship accrue to the owner (whether or not the owner withdraws all of the profits from the proprietorship) and are taxed as part of their personal income.

Partnerships

In a *general partnership*, two or more persons come together and agree to carry on an undertaking or business jointly, with the objective of making a profit. Normally, this relationship comes into being by the positive acts of the parties but it may also arise by implication of law. Not every business relationship results in a partnership, but any sharing of profits tends to prove the existence of one. The parties will usually agree to form a partnership by means of a contract, known as a partnership agreement, spelling out the complete terms of their relationship. This will be registered under the *Partnership Act*. The partnership then takes on a personality of its own, although whether it becomes a distinct and separate legal entity is a matter of debate.

general partnership
a form of organization in which two or more persons carry on a business with a view to profit

A partnership can certainly carry on business in its own name by operating through one or more of the partners or its employees. A partnership is not a taxable separate legal entity; it is a "conduit" through which any income flows through to the partners according to their partnership agreement. The income is not taxed at the partnership level, but as part of each partner's personal tax return.

The most important legal consequence of its establishment, flowing from the basic notion that all partners are agents for one another, is that each general partner becomes personally liable for all the debts incurred in the ordinary course of business regardless of whether the partner approved of what was done.

Between the partners themselves, the partnership agreement will govern their relationship. It will provide conditions for the management of operations, conditions on which a new partner will be admitted, and the consequences of the death of a partner. These provisions do not affect the public in their dealings with the partnership. For example, the partnership agreement may provide that only the most senior partner can sign contracts on behalf of the partnership. However, if a junior partner signs a contract with a supplier who believes the junior partner has authority to enter contracts on behalf of the partnership, the contract is binding on all general partners. However, in such an instance, the other partners could seek to recover their losses from the junior partner who exceeded their authority.

For both sole proprietorships and partnerships, personal liability insurance is a key business consideration.

Limited Partnership

A *limited partnership* consists of one or more general (or managing) partners, and one or more limited partners. The general partners actively carry on the business of the partnership and have unlimited liability (the same as the partners in general partnerships). The limited partners are passive investors. They may receive income from the partnership, but provided they do not take part in the day-to-day operations of the partnership, their liability to creditors is limited to the amount of capital that they have contributed to the partnership. If a limited partner becomes active in the management of the firm, they risk being deemed as a general partner and thus becoming exposed to unlimited liability.

limited partnership
a form of organization similar to a general partnership, consisting of one or more general (managing) partners and one or more limited partners

While a key legal difference exists between a general and a limited partnership in terms of the liability of the general and limited partners, both entities have the same income tax status. For real estate investment, partnerships offer some tax benefits that are not available to corporations, but in general, partnerships are considered too risky an investment vehicle. One of the main benefits of limited partnerships for real estate investment has been to gain these tax advantages, without exposing the investors (the limited partners) to unlimited liability.

Limited Liability Partnership

A *limited liability partnership* (LLP) is a variation of a general partnership, often used in professional services firms. Each limited partner in an LLP can make management decisions for the enterprise. In other words, the partners are active, rather than passive investors. However, similar to the limited partners in a limited partnership, each partner's liability for the overall debts of the LLP and the wrongful actions of other partners is limited to their investment, with two caveats:

- Each partner remains personally liable for their own negligent or wrongful acts or omissions, beyond their investment in the LLP; and
- Any partner may lose this limited liability and be held personally liable for the acts of another partner or an employee of the partnership if they had knowledge of these acts and failed to take reasonable actions to prevent them.

limited liability partnership (LLP)
a variation of a general partnership, where the partners are actively involved in the business and have limited liability

There are two main reasons for LLPs:

- Partners are accountable to their clients or customers; and
- All partners have the ability to be active in their business without exposing themselves to personal liability for the acts of their other partners (beyond the value of their investment in the partnership).

Despite the fact that LLPs can generally be used to conduct any business activity in BC, including real estate brokerages, the LLP structure has primarily been used in BC for law, notary, and accounting firms.

Overall, partnerships are less common than corporations in real estate professional services firms. Firms with multiple partners have traditionally been structured as corporations because of the improved tax planning potential and the formalization of ownership interest through share ownership, which can also simplify succession planning.

Example: Partnership Liability

Six businesspeople decide to form a partnership. Each of the six partners contributes $50,000 and shares equally in the partnership. Soon after the partnership is formed, one partner defrauds a client, who obtains a judgment for $500,000 against the partnership. However, the partnership has only $300,000 in capital.

If the partners had formed a general partnership, any of the six partners is personally liable for some or all of the remaining $200,000 of the judgment. If one partner could not pay their share, the remaining general partners would be liable.

On the other hand, if the partners had formed a limited partnership with two general partners and four limited partners, the four limited partners would not be responsible beyond their initial $50,000 commitment. The two general partners would be liable for the extra $200,000 on the judgment.

If the partners form a limited liability partnership (LLP), the partner who committed the fraud could be held personally liable for any part of the judgement that exceeds the partnership capital. Once the assets of the partnership are exhausted, they will be solely liable for the remaining $200,000 of the judgement. The other partners lose their $50,000 investment, but as long as they were unaware of the fraudulent actions and/or took reasonable steps to prevent these actions, the other partners may avoid further liability for this additional amount.

Corporations

The limited company, or *corporation*, is a business entity that is created by a Certificate of Incorporation issued by the provincial or federal government. The company is owned by one or more shareholders. The initial sale of common shares will typically form the original equity (shareholders' equity) of the corporation. Corporations exhibit enormous diversity, ranging from a small shop employing two or three persons and owned by one shareholder, to a worldwide operation employing thousands and owned by many thousands of shareholders. A company whose shares are traded on a stock exchange is referred to as a public company, whereas those whose shares are not traded on an exchange are classified as private companies.

corporation
a business entity that is owned by shareholders who decide on the general policies of the company through their elected Board of Directors; a separate legal entity that has the rights and liabilities of an individual

The shareholders have input in the general policies of the company to the extent that they elect the directors, but the board of directors manages the company in accordance with the *Canada Business Corporations Act* and their company's Articles free from any shareholder interference whatsoever. The directors are primarily liable to the company rather than to the shareholders. In fact, their responsibility in this regard is very similar to that of an agent to their principal. Thus, there exists the duty of full disclosure and the duty not to take personal advantage of information that would benefit the company. A director who fails in any of these duties can be held personally accountable.

The liability of a common shareholder is quite different from that of a general partner; shareholders are liable only for the value of the shares purchased or agreed to be purchased. The shareholders have no further responsibility for the company debts once the cost of their shares has been fully paid. This is a primary reason that owners of small businesses frequently incorporate; if their company fails, their personal assets are not at risk. A corporation can also borrow money (debt) in a variety of ways including bank loans, bond issues, or mortgages. However, given the limited liability of the owners, lenders may be wary of loaning large amounts to firms that have insufficient assets to provide security for the loan. Hence, for smaller corporations, lenders often require directors or shareholders to personally guarantee repayment of the loan.

A corporation is a separate legal entity; it has its own personality separate from the shareholders or owners, and its own income tax status. Tax advantages are a second reason that small business owners often consider incorporating. The corporation pays income tax at a flat rate that is typically lower than personal tax rates. The corporations may then pay out the income to shareholders in the form of *dividends*, which have a beneficial tax treatment compared to personal income. Alternatively, the corporation may choose to withhold income as *retained earnings*, deferring further taxation for owners. One disadvantage of corporations – at least as an investment vehicle to purchase real estate – is they may somewhat limit the potential for tax sheltering, especially with respect to capital cost allowance (discussed in more detail later in this chapter).

dividend
payment made by a company to its shareholders, either as cash or stock

retained earnings
the net income of current and prior periods less dividends paid, belonging to the shareholders of a corporation

Finally, "a company never dies"; that is, since the shares pass from one owner to another, the company exists until it is terminated by an act of those shareholders. In comparison, a partnership may terminate upon the death of a partner unless other arrangements have been made in the partnership agreement.

In summary, important issues with regard to corporations include the following:

- The company is a separate legal entity; it may acquire, hold, and dispose of assets, enter contracts, and sue or be sued.
- The company is subject to income tax, unlike partnerships, which are not subject to income tax.
- Individuals who acquire shares in a company do not own the assets of the company; they only own the shares and the rights and obligations that go with ownership of the shares.
- The shareholders do not share directly in the income of the company; shareholders' earnings arise either from capital gains on the resale of the shares, from dividends (a distribution of profits), or from participation in the surplus in the event the company is wound up.

FIGURE 8.1: Forms of Organization

Ownership	Transferability/Liquidity	Taxation	Liability
Sole Proprietorship	Lifespan limited to proprietor	Profits of the proprietorship included in owner's personal tax return Generally can deduct business losses from other sources of income Flow-through entity	Proprietor has managerial function Proprietor is personally liable
General Partnership	Subject to the terms of the partnership	Partners file personal tax returns that include their portion of partnership income Generally can deduct business losses from other sources of income Flow-through entity	Partners all active in management of partnership General partners are jointly and severally liable
Limited Partnership			Limited partners are passive investors with liability limited to their share of investment If a limited partner becomes active, they risk being declared a general partner, with associated unlimited liability
Limited Liability Partnership			Partners all active in management of partnership Partners are personally liable for their own negligence and otherwise liable for their share of investment

Ownership	Transferability/Liquidity	Taxation	Liability
Corporation	Indefinite life	Separate legal entity Shareholders file personal tax returns with salary and/or dividend income Corporation files a corporate return Cannot deduct business losses from other sources of income	Shareholders' liability limited to their investment Directors are generally not personally liable Employees are generally not liable if acting within the scope of their employment
Trusts	Liquid – REITs	Unitholder/Trustholder pays tax Flow-through entity if CRA rules met	Limited

Business Associations as a Means to Invest…

Trusts and REITs

A trust is not a form of business operation, but can serve as a means for people to collectively invest. In a basic structure, a trustee holds assets in their name ("in trust") for the benefit of the investors (beneficial owners). The trustee manages the assets, as agreed upon by the individual participants, and any subsequent profits or losses are passed onto the beneficial owners.

A simple example is a "family trust", whereby the children/beneficiaries do not at that time "own the assets" of the trust; rather, they own the right to receive their share of the income. The capital of the trust will ultimately be distributed in accordance with the deed establishing it.

Real Estate Investment Trusts (REITs) are an example of using a trust to collectively invest in mortgages and real estate assets. The assets are placed in trust and beneficial interests/trust units are sold to investors who share in the annual income from those assets. As long as the trust meets Canada Revenue Agency (CRA) rules, the income earned by the trust is not taxed. Rather, the income distributed to the beneficial owners of the trust units is included as part of their individual taxable income and subject to income tax.

In terms of liability, the beneficial owners are generally liable only for the amount committed to the purchase of the trust units. In this regard, the trust offers the same liability protection of the corporation, but also potentially the tax advantages of a partnership. As well, REITs offer excellent liquidity, with listings on major public stock exchanges. They are a simple, advantageous way for smaller investors to get involved in commercial real estate ownership.

These factors help explain the REITs growing popularity as a real estate investment vehicle, with more than 40 REITs currently available in Canada. Each fund ranges in focus, from general commercial real estate investment to specializations in retail, industrial, office, hotels, healthcare, and residential. For up-to-date information on REITs, visit the Real Property Association of Canada (RealPac) website at *www.realpac.ca*.

Joint Venture

Another type of business association is a joint venture, whose status in law is rather vague. It consists of two or more legal entities (e.g., individuals, corporations) that decide to cooperate in carrying out some undertaking. The joint venture is a vehicle by which the risks and costs of some undertaking can be shared between two or more established legal entities. Money is put into the venture (which may be to explore or develop an area) and separate accounts are maintained, with profits or losses being apportioned to the participants. The legal form of the joint venture could be that of a partnership or that of a corporation. If the joint venture is structured as a partnership, the investors are, of course, liable for the actions or debts of the joint venture. Taxation of the joint venture will generally be determined by its legal form.

FINANCIAL REPORTING

Financial reporting is how businesses summarize and report their successes, failures, strengths, and weaknesses. Financial reporting should meet the following objectives and provide information that:

- is useful to current and potential stakeholders and other users (e.g., creditors) in making rational investment, credit, and related decisions;
- assists stakeholders in assessing the performance of those engaged to manage the assets and activities of the entity; and
- is about the economic resources of an enterprise, the claims on those resources (i.e., obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims on those resources.

There are two statements in particular where the transactions of a business are summarized, classified, and communicated to interested parties:

- the *income statement* (sometimes called the revenue and expense statement or the profit and loss statement), and
- the *balance sheet* (sometimes called the statement of financial position or statement of assets and liabilities).

income statement
a financial statement listing the revenues and expenses of a business for a given period

balance sheet
a financial statement listing the assets, liabilities, and owner's equity of a business at a specific point of time

This section will outline the basics of accounting and offer a brief overview of these business statements.

Accounting Fundamentals

Accounting is the systematic recording, reporting, and analysis of financial transactions. It is the medium through which an entity records, summarizes, classifies, and communicates its activities and transactions for a given period of time. This information is important as it aids in planning and controlling routine operations, making special decisions, and formulating overall policies and long-range plans.

accounting
the systematic recording, reporting, and analysis of financial transactions

Financial statements can be considered the end result of the recording, summarizing, and classifying of the accounting process. They represent the medium through which information about transactions that occurred over a certain period of time (usually one year) are communicated to interested parties.

financial statements
the end result of the recording, summarizing, and classifying of the accounting process

Financial statements provide quantitative information about a particular entity that is intended to be useful in making economic decisions. These economic decisions usually involve making rational choices among alternative courses of action. However, not all of the information that is needed to make most decisions will be contained in these statements. Financial statements are compiled in accordance with Generally Accepted Accounting Principles (GAAP). In Canada, the primary source of GAAP is published in the *CPA Canada Handbook–Accounting* (CPACACC). In 2011, these accounting standards were separated into two sets: the International Financial Reporting Standards (IFRS) and the Accounting Standards for Private Enterprise (ASPE).

The ASPE are sometimes referred to as PE-GAAP (Private Enterprise Generally Accepted Accounting Principles). Publicly accountable enterprises (generally those companies whose shares or debt are traded on an exchange) must prepare financial statements in accordance with the IFRS. Non-publicly accountable private business enterprises may choose to comply with either the IFRS or the ASPE. Because the costs involved in using IFRS for most private enterprises will exceed the benefits of their use, most Canadian private companies elect to report in accordance with ASPE unless they plan to issue an initial public offering (i.e., become a public company) in the foreseeable future.

Accounting Note: GAAP versus IFRS

Accounting standards in Canada changed in 2011, from the long-standing GAAP standard to IFRS. The key change for real estate was reporting asset value on the balance sheet at fair market value rather than depreciated cost. This means appraising asset values quarterly or annually versus setting asset values at historic cost or book value (initial cost minus accumulated depreciation). The move to IFRS was mandatory for publicly traded companies and optional for other businesses, most of which stayed with GAAP. Therefore, for the purposes of this chapter and the course, Canadian GAAP (PE–GAAP/ASPE) principles will be applied in the examples and illustrations.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

To understand and interpret financial statements, it is important to be familiar with the following accounting principles.

Cost Principle

The cost principle is commonly referred to as the historical cost principle. It holds that when a business enterprise acquires an asset, the asset's historical cost (i.e., the amount paid for the asset) is the appropriate amount to record in the books of the enterprise. While this seems obvious, it should be pointed out that at times an enterprise may acquire an asset for an amount that is greater or less than the asset's *fair market value* on the date of the transaction. To conform with the cost principle under GAAP, it is not appropriate to record the asset at what might be considered its fair market value; the asset should be recorded at the amount that the enterprise paid for it.

fair market value
the price at which an informed buyer and seller would be willing to transact a trade of a given asset

Revenue Recognition Principle

Revenue is usually the amount received or receivable by an entity for the provision of goods or services. The revenue recognition principle holds that revenue should be recognized by an enterprise when it is earned, not necessarily when cash is received. This is referred to as the accrual basis of accounting as opposed to the cash basis. For example, under the accrual method of accounting, a real estate representative may record the commission earned from the sale of a house on their accounting records when the subject clauses were removed from the contract of purchase and sale, even though the money for the commission may not be received until the completion date – this is assuming that all other services that are required by the agent contract have been fulfilled. On the other hand, the cash basis would not allow the commission to be recorded until the cash was actually received. The accrual basis of accounting is required by generally accepted accounting principles and will be used throughout the chapter.

The timing of revenue recognition is highly dependent on the terms of the agent contract that the seller and agent have agreed to. For example, if the agent contract specifically states that "if the transaction is not completed for any reason, then the agent is not entitled to the fee", then revenue should not be recognized until transfer of title has occurred. On the other hand, if the agent contract states that the agent has rendered/fulfilled the services once the subjects have been removed, then revenue recognition can be considered at that time. Therefore, commissions earned from the sale of a property can be recognized at either title transfer or at subject removal, depending on the circumstances. In practice, revenue is most often recognized when title is transferred.

Matching Principle

The matching principle holds that expenses directly associated with particular revenues should be recognized in the same period in which the revenue is recognized. Other expenses should be recognized in the period in which the goods or services are consumed. In other words, insurance costs covering a calendar year should be recognized each month, not all in the month in which the insurance begins or the month in which the premium is paid. Costs that benefit more than one period (e.g., month) should, to the extent practical, be recognized over the period benefited by the costs. As with the revenue principle, the matching principle requires the accrual basis of accounting be used for maintaining records of the entity; that is, expenses are recorded when incurred, which is not necessarily when they are paid.

Materiality Principle

The *materiality* principle is an exception to the matching principle. Purchases with a relatively low cost that are used up over a period of several months, such as stationery or cleaning supplies, may be immediately expensed when acquired. The effort involved to allocate these costs over their period of use exceeds any conceivable benefit. The threshold for materiality is if the cost is likely to impact any decisions or judgements made by the users of the financial statements. If the cost of the stationery and supplies is below that threshold, these items should be expensed when acquired and not spread over the months in which they are used. Conversely, where a large cost (e.g., insurance) is incurred that benefits the entire year, the cost should be allocated in accordance with the matching principle.

materiality
likeliness of a piece of financial information to impact decisions or judgements made by users of the financial statements

Objectivity Principle

The objectivity principle holds that all accounting information should be reported on objectively determined and verifiable data. This principle is closely aligned to the cost principle because the best way to ensure objectivity in accounting transactions is to record the amount of consideration (usually money) given up at the date of the transaction. If accounting information is recorded on a cost basis, this information can be certified by an independent party (such as an auditor, if an audit was performed).

Consistency Principle

Accounting recognizes that alternatives exist in the recording of transactions and, in certain cases, generally accepted accounting principles allow the same transaction to be recorded in more than one way.

The consistency principle holds that once a business enterprise adopts one generally accepted accounting principle from a number of alternatives, the enterprise should follow that same principle in subsequent years. This does not mean a business enterprise is prohibited from changing from one generally accepted accounting principle to another that is more appropriate. However, if an entity were to do this frequently, it would render the financial statements virtually meaningless, since users would not be able to assess performance from one year to the next. Changes to accounting principles should only be made where the change results in providing more relevant and useful information to the user of the financial statements.

Fiscal Year

A fiscal year is a period used for all taxpayers to compute their financial statements for taxation. Individuals use the calendar year as their taxation year. Corporations report their income on the basis of a fiscal period that may be different from the calendar year.

Corporations can initially choose any fiscal period, but then must consistently report income for tax purposes on that basis. No taxation year may be longer than 53 weeks, and a change of year end may be made only with approval from the Minister of National Revenue. There are certain circumstances where a corporation's taxation year may be deemed to end; for example, an amalgamation is deemed to cause the end of a taxation year.

FINANCIAL STATEMENTS

Financial reports are used by the firm's internal users – the owners and managers – and by a wide range of external users.

There are two main categories of financials statements:

- Statements prepared for the internal use of the enterprise, known as internal or management reporting; and

- Statements prepared for external purposes, referred to as financial reporting.

In order to minimize accounting costs, most businesses will develop one set of financial reports used for both internal and external reporting. At a minimum, the business must produce a balance sheet, an income statement, and a statement of retained earnings. Some businesses might also elect to produce a cash flow statement.

Notes and Comments

Most sets of published financial statements include explanatory notes. These notes are an integral part of the financial statements. Their purpose is to add clarity to the information conveyed. The notes indicate the actual accounting methods used by the entity and disclose additional information relating to what is presented in the financial statements. A careful reading of the notes that are appended to the financial statements is necessary to fully understand what is contained in the statements.

While it is beyond the scope of this course to examine the details of financial statements, the following sections will explore some key points relating to balance sheets and income statements. As well, some key differences will be identified between the income statement and income tax return.

Balance Sheet (or Statement of Financial Position)

A balance sheet is a listing of the assets, liabilities, and owners' equity of a business enterprise at a specific point in time. It is similar to the listing of an inventory at a specific date and is like a snapshot of the financial affairs of the enterprise.

The balance sheet shows the assets (i.e., items of value) owned by the enterprise, as well as how these assets have been financed. An entity acquires assets either by borrowing the money from creditors (debt financing) or by using the money provided by the owners for the enterprise (equity). Therefore, there are two sources of financing for the acquisition of assets: creditors and owners. The liabilities of an entity are the items that are owed by the enterprise to others outside the business, representing the equity that the creditors have in the enterprise. Owners' equity is, as the name implies, the equity that the owners have in the entity. The relationship between these three elements is expressed by the balance sheet equation:

ASSETS = LIABILITIES + OWNERS' EQUITY

Put another way, the total of the assets of an entity must equal the total of its sources of capital.

Balance Sheet Classifications

When listing the assets, liabilities, and owners' equity in the balance sheet, accountants attempt to classify assets and liabilities into the following logical groupings.

Current Assets

Current assets are those that will be converted into cash, sold, or consumed within one year or within the normal operating cycle of the business – whichever is longer. Current assets are listed in order of *liquidity* (items most readily converted into cash would be listed first). Examples of current assets include cash, marketable securities, accounts receivable, inventories, and prepaid expenses. These are defined as follows:

- Marketable securities are temporary investments of a business enterprise in the securities of another company (including government bonds). In order for this type of investment to be classified as a current asset, it must meet two criteria:
    - the investment must be readily convertible into cash; and
    - management must not intend to keep the investment for more than one year.

current assets
assets that will be converted into cash, sold, or consumed within one year or the normal operating cycle of the business, whichever is longer

liquidity
the degree to which an asset can be readily converted to cash

Marketable securities are generally valued at their market value on the balance sheet date with any gain or loss on revaluation included in the income of the period.

- Accounts receivable are revenues due from customers for the rendering of services or sale of goods for which cash has not yet been received.
- Inventories include items that are being held for resale to customers and/or supplies that have been acquired for use in the business but not yet used.
- Prepaid expenses represent services or rights to services for which cash has been paid but the services have not yet been consumed by the business at the time the balance sheet is prepared; e.g., prepaid rent or prepaid insurance premiums.

Inventory Valuation

The inventory of the business is often purchased separately from the business itself. The method for valuing the inventory should be referred to an independent advisor of your choice and a valuation date agreed upon by everyone prior to entering into the contract of purchase and sale. It is important to seek the guidance of those experienced in evaluating inventory. The contract must state clearly whether or not the price includes inventory. Some concerns are described in the following examples:

- **Shoe stores:** stock on hand includes not only current styles, but also boxes of out-of-fashion shoes;
- **Grocery stores:** stock includes large amounts of time-dated products and foods;
- **Florist shops:** stock includes aging, wilting, and dying flowers;
- **Gift stores:** stock includes items that a buyer is not interested in buying at all or for which they do not see a market; and
- **Lawn mower and small engine repair shops:** stock includes boxes of parts for old and obsolete engines.

One of the differences between residential and business/commercial transactions is that often the parties involved in the transaction are far more knowledgeable than the licensees in the operation of the particular business and, more than likely, meetings and discussions have taken place previously between the business owner and prospective purchaser. Frequently, the function of the licensee is to put into an agreement format those things that have already been discussed and agreed to by them.

Source: BCFSA's Advertising Consumer Guide, available online.

Non-Current Assets

Non-current assets are assets that will not be sold or consumed within one year or the normal operating cycle of the business. These include investments that management has no intention of selling within a year, as well as property, plant, and equipment.

non-current assets
assets that will not be sold or consumed within one year or the normal operating cycle of the business

Assets included under the caption "property, plant, and equipment" are assets from which benefit or use can be derived over more than one accounting period. Because the benefits from these assets last more than one accounting period, the matching principle dictates that the costs of these assets cannot be charged off or "expensed" in any single year. The cost of these assets must be allocated over the years in which the benefit is derived. This allocation process will be achieved through the use of depreciation expense, which will be discussed later in this chapter. The amount shown on the balance sheet as non-current assets will be the original cost of the asset less all the depreciation that has accumulated to date. This net amount is referred to as the net book value of the asset.

Current Liabilities

Current liabilities are liabilities that the enterprise expects to pay off within one year. Examples of current liabilities include accounts payable, wages payable, income taxes payable, interest payable, and property taxes payable.

current liabilities
liabilities that the enterprise expects to pay off within one year

- Accounts payable represent amounts owed by the business enterprise for services or goods received but not yet paid for.
- Wages payable are wages owed to employees. Employees are not usually paid in advance. Wages for which an employee has rendered service but has not yet been paid for will fall under the category of current liabilities.
- Income taxes payable are not present on the financial statements of a partnership or proprietorship since partnerships and proprietorships

do not themselves pay income tax, but appear on the financial statements of a corporation since corporations are separate entities for income tax purposes. This amount represents the income tax owed, but not yet paid.

- Current portion of long-term debt includes any portion of the principal balance of long-term debt that will be payable within one year of the balance sheet date.
- Property taxes payable are those property taxes that have accrued but have not yet been paid for.

Non-Current Liabilities

Non-current liabilities are liabilities that are not expected to be paid within one year. Non-current liabilities include the different forms of long-term debt; the most common of these, from a real estate viewpoint, is a mortgage.

non-current liabilities
liabilities that the enterprise does not expect to pay off within one year

Balance Sheet – Proprietorship (Exhibit 8.1)

On December 31, 20X0, Joe Gottrich became involved in the rental of property. He invested $100,000 of his own money in this business. On this date, he purchased a rental building at a cost of $320,000, using a down payment of $95,000 and taking out a mortgage of $225,000 for the balance. The mortgage is amortized with annual payments. The annual principal repayment for the first year is $4,600. $150,000 of the total cost of $320,000 was allocated to the land and $170,000 to the building.

On December 31, 20X0, after this transaction, Joe Gottrich's Balance Sheet will be as follows:

FIGURE 8.2: JOE GOTTRICH (Proprietorship), BALANCE SHEET as at December 31, 20X0

ASSETS		
Current:		
Cash		$5,000
Non-Current:		
Land	$150,000	
Building	170,000	
Less accumulated depreciation	(0)	320,000
TOTAL ASSETS		$325,000
LIABILITIES & OWNER'S EQUITY		
Current:		
Current portion of mortgage payable		$4,600
Non-Current:		
Mortgage payable	$225,000	
Less current portion	(4,600)	220,400
TOTAL LIABILITIES		$225,000
Owner's Equity:		
Joe Gottrich, Capital		100,000
TOTAL LIABILITIES AND OWNER'S EQUITY		$325,000

The cash balance of $5,000 in Figure 8.2 represents the amount of cash on hand and in the business bank account at December 31, 20X0. Joe initially invested $100,000 in the business and then used $95,000 for the down payment to purchase the apartment property.

The balances shown under non-current assets represent what Joe paid for the building and land. In all future years, as long as Joe owns this building and land, these assets will be shown at these same values regardless of the fact that the current market value may change. For this reason, it is often misleading to look at a balance sheet to determine the net worth of a business, since the value of the assets and liabilities listed here may bear little or no relationship to their current market value. The non-current asset section of the balance sheet also shows the amount of depreciation that has accumulated over the life of the asset. This accumulated depreciation is subtracted from the noncurrent assets and the net amount (i.e., the net book value) is also shown on the balance sheet. In Figure 8.2, the accumulated depreciation is zero since Joe Gottrich has only been in business for one day. However, if the accumulated depreciation had been $20,000, then the net book value of the non-current assets would have been $300,000 rather than the $320,000 shown.

The mortgage, a non-current liability, is classified as mortgages payable on the balance sheet – the amount still owing on the principal of a mortgage. The amount of the principal to be paid on the mortgage in the year following the current accounting year is deducted from non-current liabilities and shown as a current liability. This is because the principal portion of the annual mortgage repayment due in the next accounting year has become a liability that is expected to be paid in one year. Note that the amount of the current portion will generally increase each year since the principal portion of repayments increases each year on amortized mortgages with fixed monthly payments. The interest portion of the mortgage repayment is dealt with in the income statement and explained later in the chapter.

The amount shown in Joe's owner's equity account represents his investment in the business.

Balance Sheet – Partnership

If this same enterprise started off as a partnership (either general or limited partnership) with Joe and his friend Susan D. Prived as partners and each one put up $50,000, the owner's equity section in the balance sheet and the title of the balance sheet would change. No other changes would occur if this were a partnership. For example, the owners' equity would read as follows:

Joe Gottrich, Capital	$50,000
Susan D. Prived, Capital	50,000
	$100,000

Similarly, the title of the balance sheet would change to Joe Gottrich and Susan D. Prived (Partnership).

Balance Sheet – Corporation

The balance sheet for a corporation would differ only slightly. Regardless of the type of business organization, assets and liabilities would be the same. However, differences occur in the owners' equity section (as previously illustrated for sole proprietorships and partnerships).

In a proprietorship, the equity section was entitled "Joe Gottrich – Capital." In this account, all of the investments made by the owner in the business, as well as profits and withdrawals, would be reflected. For a partnership, the equity section would retain a capital account for each of the partners and, like the proprietorship, investments and withdrawals made by each partner would be reflected in their capital account.

In the case of a corporation, the owners' equity is referred to as shareholders' equity. There are two major classifications in the shareholders' equity section. The first is referred to as "share capital" and represents the investment made by all of the owners (shareholders) of the corporation. The second part is known as "retained earnings" and represents the accumulation of net income of the corporation from the time of its inception less any withdrawals paid to the shareholders in the form of dividends.

If this same enterprise started off as a corporation, with Joe and Susan as shareholders in JG Corporation, only the shareholders' equity section in the balance sheet would change. For example, the shareholder's equity would read as follows:

Share Capital: 100 voting shares @ $1,000 par value	$100,000
Dividends Declared	0
Retained Earnings	$100,000

The retained earnings is simply the accumulated net income (and losses) of the corporation for the current and all prior periods less any amounts withdrawn (in the form of dividends) by the owners. Retained earnings for JG Corporation are $0 because the firm just started operations. We will revisit this category in the year-end balance sheet.

In addition, companies reporting under the International Financial Reporting Standards (IFRS) have the option of revaluing their property, plant, and equipment to its fair market value periodically. This option is not available to companies reporting under the Accounting Standards for Private Enterprise (ASPE). Note that it is rare for private Canadian companies to use IFRS, given the additional accounting expense and minimal benefit. These firms continue to report property, plant, and equipment at original cost less subsequent accumulated depreciation.

Finally, note that the title is changed to the name of the company, JG Corporation (Figure 8.6), and that the names of the owners of the business are no longer shown on the financial statements. This lack of information is known as the corporate veil. The statements show only the number of shares, their value, and the rights attached to them.

Income Statement (Revenue and Expense or Profit and Loss Statement)

The income statement is a listing of the revenue and expenses of the business enterprise for a particular period of time, usually one year. This is different from the balance sheet, which shows the assets, liabilities, and owners' equity at a particular date. The income statement may be for any period of time – a month, a quarter, six months, or a year. It would not usually be drawn up for a period exceeding one year. This statement can be seen as a motion picture covering a period of time. The general format of the income statement is:

REVENUE – EXPENSES = NET INCOME

Revenue

Some common types of revenue include:

- Sales revenue is revenue realized from the sale of goods.
- Interest revenue is revenue realized from lending money or placing money in a bank account.
- Service revenue is revenue realized from the rendering of services such as those services rendered by a physician, accountant, or real estate licensee.
- Rent revenue is revenue realized from the renting or leasing of space the business owns.

Expenses

Expenses are defined as the cost of items or services consumed in order to produce revenue. When the total revenues for a particular period exceed the total expenses for that period, the difference is referred to as *net income*. When the reverse is true (total expenses exceed total revenues for the period) the difference is referred to as net loss. Common expenses include interest expense and property taxes. Two other expense items – cost of goods sold and depreciation – are discussed in more detail in the following sub-sections.

net income
the amount by which revenues exceed expenses in any given time period

Cost of Goods Sold

For a business enterprise that derives its revenue through the sale of goods, the cost of goods sold is an important category. When a business enterprise acquires goods for resale, it does not expense them until they are actually sold; that is, the cost of the goods is not deducted from revenue on the income statement until they are actually sold. To treat the cost of these goods as an expense before they are sold would violate the matching principle. Hence, the cost of goods sold as illustrated below is necessary in order to determine the cost associated with the enterprise's revenue for a given period of time. This type of expense would not be present in a service enterprise since no goods are sold, only services.

Example: Cost of Goods Sold

	Beginning inventory	$36,000
+	Purchases of goods for resale	120,000
–	Ending inventory	(40,000)
=	Cost of goods sold	$116,000

The firm began the period with $36,000 of existing inventory. During the period, they bought $120,000 worth of inventory. At the end of the period, the firm was left with $40,000 worth of inventory, so they must have sold inventory worth $116,000 during the period.

Depreciation (or Amortization) Expense

Reference has been made in the discussion of the matching principle and non-current assets to the need to allocate the cost of assets that benefit the business enterprise for more than one accounting period. For depreciable assets (assets that are used up over a period of time through wear and tear), depreciation expense is the method used by accountants in financial statements to allocate the cost of the asset over time. Examples of depreciable assets are buildings and equipment. Land is not considered to be a depreciable asset, thus depreciation expense is never taken on land.

Accountants calculate depreciation expense by a number of different methods, in accordance with generally accepted accounting principles. The simplest and most common method is the straight-line method.

Under the straight-line method, an estimate is made at the time an asset is purchased (i.e., its acquisition date) of how many years the asset will be of economic benefit to the enterprise. This estimate of the number of useful years is termed the economic life of the asset. In other words, for how many years will the asset be beneficial to the enterprise in contributing to revenue? An estimate is also made of the amount that can be realized from the sale of the asset at the end of its useful life. This is called the *salvage value* of the asset. Since the enterprise may expect to recover some of the cost of the asset when it is resold, it would be illogical to expense all of the original cost of the asset because not all of its cost will be consumed by the business enterprise. The economic life of a building is determined through consultation with experts who can estimate how long a building will last, considering its use.

salvage value
an estimate of the amount that can be realized from the sale of the asset at the end of its useful life

The depreciation expense is then computed by subtracting the estimated salvage value from the cost of the asset and dividing the remaining amount by the estimated number of years the asset will be of use. (It is possible for the estimated salvage value to be zero.) This figure will be the amount of depreciation expense that will be recorded each year as long as the asset is being used to generate revenues.

Example: Depreciation Expense

Cost of a Machine	\$600,000
Estimated Economic Life	10 years
Estimated Salvage Value (at the end of 10 years)	\$50,000

$$\text{Annual Depreciation Expense} = \frac{\text{Cost} - \text{Salvage Value (if any)}}{\text{Estimated Life (years)}}$$

$$= \frac{\$600{,}000 - \$50{,}000}{10}$$

$$= \$55{,}000 \text{ per year}$$

Depreciation expense is an attempt to allocate the cost of the asset over its useful life. It should be noted that depreciation expense is an accounting concept that follows the matching principle – allocating the expense or wear and tear incurred to the revenue earned in that period, and applicable only in the firm's financial reports. Canada Revenue Agency (CRA) will only recognize depreciation as a tax deduction if it is calculated using the capital cost allowance (CCA) in determining taxable income. This will be discussed in the Income Tax Return section.

Income Statement – Proprietorship (Exhibit 8.2)

Returning to our example of Mr. Joe Gottrich, sole proprietorship, the following occurred in the first year. During 20X1, the enterprise earned \$67,600 in rent but they had only collected \$47,350 in cash by year end. A total of \$27,000 was paid on the mortgage, of which \$4,600 represented a repayment of the principal and the other \$22,400 was payment of interest. The enterprise also incurred operating expenses of \$9,488, of which only \$7,088 had been paid for by December 31, 20X1. Property taxes of \$5,415 were paid for in cash during the year. The building cost \$170,000 and is expected to last 10 years, at which time the salvage value is estimated to be \$20,000.

The following income statement would be drawn up for the year ending December 31, 20X1 (on the basis that this is a proprietorship owned solely by Joe Gottrich).

FIGURE 8.3: JOE GOTTRICH (Proprietorship), INCOME STATEMENT for the Year Ending December 31, 20X1

Revenue:		
Rents earned		$67,600
Expenses:		
Interest	$22,400	
Operating expenses	9,488	
Property taxes	5,415	
Depreciation	15,000	52,303
Net income (before taxes)		$15,297

Even though Joe collected only $47,350 in cash from the tenants by year end, the enterprise earned $67,600. Therefore, in order to conform with the revenue principle and the accrual basis of accounting, $67,600 is the appropriate amount to record as revenue. Joe paid $27,000 on the mortgage, but $4,600 was a repayment of the principal. This reduction in principal of $4,600 is not considered to be an expense and therefore is not included as such. However, the interest portion of the payment is considered an expense and is deducted from revenue. Only $7,088 of operating were paid for in cash by Joe, but total operating expenses incurred for the fiscal year were $9,488. To conform with the matching principle and the accrual basis of accounting, $9,488 is the appropriate amount of operating expenses to record.

The depreciation expense of $15,000 was computed as follows: Joe decided that the building would last 10 years and at the end of that time, the salvage value of the building would be $20,000. Therefore, each year depreciation expense of $15,000 (1/10 of $170,000 – $20,000) should be taken.

$$\text{Depreciation Expense per Year} = \frac{\text{Cost} - \text{Salvage Value (if any)}}{\text{Economic Life (years)}}$$

$$= \frac{\$170{,}000 - \$20{,}000}{10}$$

$$= \$15{,}000$$

Land is not a depreciable asset so no depreciation is calculated on this item.

Income tax expense is not recorded here. As discussed earlier, neither partnerships nor proprietorships pay income taxes. This does not mean that the income earned by these enterprises is exempt from taxes. When Joe is completing his personal income tax return, he would have to include the taxable income from his rental business.

Income Statement – Corporation (Exhibit 8.3)

On an income statement for a corporation, income tax has to be deducted in determining the company's net income. It is important to remember that depreciation expense is not a deductible expense in computing taxable income, but capital cost allowance is. Therefore, net income that is reported on the corporate income statement will not necessarily be the same as taxable income that is reported on its income tax return. These differences occur due to Canada Revenue Agency's rules for calculating depreciation; that is, using capital cost allowance (CCA).

For JG Corporation, the income tax payable (using CCA) is calculated as $3,545. This is explained in detail later in the Income Tax Return section.

FIGURE 8.4: JG CORPORATION, INCOME STATEMENT for the Year Ended December 31, 20X1

Revenue:		
Rents earned		$67,600
Expenses:		
Interest	$22,400	
Operating expenses	9,488	
Property taxes	5,415	
Depreciation	15,000	52,303
Net income (before taxes)		$15,297
Less: income tax		($3,545)
Net income (after taxes)		$11,752

Owners' Equity and Retained Earnings

The income statement and the balance sheet show two separate aspects of the business. However, these reports are linked by the net income earned or net loss incurred within the fiscal period. At year-end, the amount of the net income or net loss is transferred to the owners' equity account in the balance sheet. That is, if there is a net income, it is added to owners' equity while a net loss is subtracted from owners' equity.

In the case of a proprietorship or partnership, the amount of net income would increase the capital account of the proprietor or partners whereas the amount of the net loss would reduce these accounts.

In a corporation, the net income or net loss is transferred to the retained earnings account. The retained earnings is simply the net income (and losses) of the corporation for the current and all prior periods less any amounts withdrawn (in the form of dividends) by the owners.

Thus, the net income or loss serves as the connecting link between the income statement and the balance sheet. For example, if, at the start of the fiscal period, the owners' equity account contained $100,000 and the enterprise suffered a loss of $15,000, the owners' equity account would now contain $85,000. If instead of a loss of $15,000 there was a gain or net income of $15,297, such as in our example, the owners' equity account would be $115,297 at the end of the year.

Another way of looking at the balance sheet equation is:

ASSETS – LIABILITIES = OWNERS' EQUITY

It follows that if the net assets (assets minus liabilities) of a business enterprise have increased from the beginning of one fiscal period to the end of the fiscal period, the owners' equity must have increased as well (even if the owners of the enterprise have made compensating withdrawals of their equity during this period).

Year-End Balance Sheet – Proprietorship (Exhibit 8.4)

The balance sheet for Joe Gottrich, proprietor as at December 31, 20X1 would be:

FIGURE 8.5: JOE GOTTRICH (Proprietorship), BALANCE SHEET as at December 31, 20X1

ASSETS		
Current:		
Cash		$12,847
Rent receivable		20,250
Non-Current:		
Land		150,000
Building	$170,000	
Less accumulated depreciation	(15,000)	155,000
TOTAL ASSETS		$338,097
LIABILITIES & OWNER'S EQUITY		
Current:		
Accounts payable		$2,400
Current portion of mortgage payable		5,000
Non-Current:		
Mortgage payable	$220,400	
Less current portion	(5,000)	215,400
TOTAL LIABILITIES		$222,800
Owner's Equity:		
Joe Gottrich, Capital		115,297
TOTAL LIABILITIES AND OWNER'S EQUITY		$338,097

The $5,000 cash on the 20X0 balance sheet (Figure 8.2) has increased by $47,350 from rent revenue collected, and has decreased by $27,000 in mortgage payments, $7,088 of operating expenses paid in cash, and $5,415 in property taxes paid, to become $12,847 on the 20X1 Balance Sheet (Figure 8.5).

The rent receivable balance of $20,250 ($67,600 – $47,350) shown on the year-end balance sheet represents the amount of rent earned during 20X1, but not collected in cash by year-end.

The accumulated depreciation account of $15,000 is the amount of depreciation taken up to the date at year end. The amount of $155,000 for "building" at December 31, 20X1 is known as the book value, which is the original cost of the building less the sum of all depreciation expenses taken to date.

The accounts payable balance of $2,400 ($9,488 – $7,088) is the amount of operating expenses incurred during 20X1 not paid by year end.

The current portion of the mortgage payable represents the amount of the principal that will be paid off during the year 20X2. At the beginning of 20X0, the principal outstanding on the mortgage was $225,000. During 20X1, $4,600 was paid off on the principal, leaving a balance of $220,400. Since the amount of $5,000 is now classified as a current liability, the long-term portion of the mortgage liability is now $215,400 ($220,400 – $5,000).

As discussed before, the owners' equity account reflects the investment of the owner or owners of the business plus whatever income the business earns and is reduced by any withdrawals made by the owners. At the end of 20X1 the balance in this account of $115,297 represents Joe's initial investment of $100,000 plus the net income earned by the rental business of $15,297.

Year-End Balance Sheet – Partnership

In a partnership the year-end balance sheet would be the same as that of the sole proprietorship except for the owners' equity account, which would show:

Joe Gottrich, Capital	$57,648.50
Susan D. Prived, Capital	57,648.50
	$115,297.00

Joe's capital account represents his initial investment of $50,000 plus his share of the profits for 20X1 (one half of $15,297). Susan's capital account would be calculated on the same basis. The assumption made here is that profits are to be divided evenly; however, this need not be the case. This also assumes that neither partner has withdrawn any amount during 20X1.

Year-End Balance Sheet – Corporation (Exhibit 8.5)

Except for the income taxes payable and shareholders' equity account, all other accounts are exactly the same as that shown for a proprietorship or partnership.

There is now a completely new account called income taxes payable of $3,545. As discussed before, a corporation has to pay income taxes on the income it earns. For 20X1, income tax was calculated to be $3,545 (Figure 8.4). Since the income tax return cannot be compiled until the end of the year, if we assume this corporation has not paid any instalments to Canada Revenue Agency (CRA) during the year, it now owes CRA the amount of $3,545 that was not paid as at December 31, 20X1. Income tax has been treated as an expense for 20X1 on the income statement, therefore JG Corporation has a liability to CRA of $3,545, which must be shown in the balance sheet as a current liability. It is classified as a current liability since JG Corporation must pay this amount within a very short time.

In recognizing the net income at year end, JG Corporation's share capital account remains at $100,000, but the retained earnings increase by the corporation's $11,752 net income.

FIGURE 8.6: JG CORPORATION, BALANCE SHEET as at December 31, 20X1

ASSETS		
Current:		
Cash		$12,847
Rent receivable		20,250
Non-Current:		
Land		150,000
Building	$170,000	
Less accumulated depreciation	(15,000)	155,000
TOTAL ASSETS		$338,097
LIABILITIES & SHAREHOLDERS' EQUITY		
Current:		
Accounts payable		$2,400
Income taxes payable		3,545
Current portion of mortgage payable		5,000
Non-Current:		
Mortgage payable	$220,400	
Less current portion	(5,000)	215,400
TOTAL LIABILITIES		$226,345
Shareholders' Equity:		
Shares authorized and issued:		
100 voting @ $1,000 par value	$100,000	
Retained earnings	11,752	111,752
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY		$338,097

The shareholders' equity account now shows a balance of $111,752, which represents the initial investment of the owners of $100,000 used to buy 100 shares at $1,000 each plus the net income (after tax) earned by the corporation in 20X1 of $11,752.

At this point, it is necessary to reiterate a key factor. A balance sheet does not show the value of a business. While it shows the expected cash value of current assets, the value of fixed or long-term assets is shown as the dollar amount paid to acquire the assets less accumulated depreciation. Thus, the current market price of the assets could be significantly more or less than the figures on the balance sheet. In a transaction, the purchaser and vendor will not be looking to the financial statements for current value of the long-term or fixed assets.

An additional factor that might enter into the sale of a business is *goodwill*. Assume that a purchaser calculates the current market price of the land and building to be $375,000 and, after adding the rent receivable ($20,250) and deducting the total debt ($222,800), is willing to pay Joe Gottrich an amount greater than $172,450 to purchase the property. This would mean that, due to the quality of the tenants or the location of the rental building, the purchaser expects the future income of the business to be greater than that of comparable businesses and is willing to pay more than the current value of the net assets (assets minus liabilities). The difference between the market value of the net assets and the price paid by the purchaser is known as goodwill.

goodwill
an intangible asset, accounting for the difference between the purchase price of a business and the market value of its net assets

For other businesses, this might represent the value of the brand, an established customer list, or the exceptionally efficient operations with well-trained staff – or it could simply reflect that the assets are undervalued or that the purchaser overpaid. Whether directly explainable or not, goodwill is effectively a catch-all to account for the difference between asset value in the financial reports and the purchase price.

Cash Tells the Real Story…

In preparing the balance sheet and income statement using the accrual basis of accounting, the statements accurately reflect the timing of the earnings and the expenditures to produce this income. However, the statements do not accurately reflect the timing, amount, and sources of the cash inflows and outflows during the reporting period.

The cash flow statement provides information that an owner, investor, lender or creditor would like to determine, such as the amount available for distribution to debt and equity holders, and the amount available to make loan payments.

The first step in developing a cash flow statement is to identify and measure both cash inflows from each source and cash outflows for each use. For example, cash will increase through borrowing activity and the sale of assets, while cash will decrease through the purchase of new assets and the repayment of debt.

Reviewing the financial statements for Joe Gottrich Proprietorship, Figure 8.7 shows an example of a statement of cash flows. The statement explains specifically what cash came in and where cash left the business. Of particular importance is the rents receivable – earnings showing as “earned” in the income statement, but not yet (and perhaps never) actually received. Similar is depreciation expense – an accounting expense that is not truly cash leaving the firm. The benefit of the cash flow statement is that it specifically shows how and why the cash position has changed, which can be a crucial element in business success (and in some cases, business survival). For example, if Joe’s cash flow was not from operations, but from taking on more debt or from selling off revenue-generating assets, then a seemingly “healthy” cash account could actually be a sign of problems.

FIGURE 8.7: JOE GOTTRICH (Proprietorship), Statement of Cash Flows for the Year Ended December 31, 20X1

Operating Activities:		
Net income		$15,297
Add:		
Depreciation expense[1]	+ $15,000	
Increase in accounts payable[2]	+ 2,400	
Subtract:		
Increase in rents receivable[3]	($20,250)	
Cash generated from operations		$12,447
Financing Activities:		
Decrease in mortgage payable	($4,600)	($4,600)
Investing Activities:		
None	$0	
Net increase (decrease) in cash		$7,847
Cash beginning of year (Figure 8.2)		$5,000
Cash end of year (Figure 8.5)		12,847
Net increase (decrease) in cash[4]		$7,847

1 Depreciation is a non-cash expense, meaning it is deducted on the income statement, but no cash actually left the firm in the current year.

2 Accounts payable is a liability: already deducted as an expense on the income statement, but the cash did not yet actually leave the firm's account.

3 The balance sheet item increased for this asset amount, but it represents funds declared as revenue where cash is not yet actually held by the firm.

4 The changes in the cash account on the balance sheet matches the analysis of changes in the other accounts, reconciling the difference in the firm's cash position from last year to this year

INCOME TAX RETURN

The income tax return, is not filed by either sole proprietorships or partnerships; rather, the income flows through to the owner or partners who declare income on their personal returns. In the case of corporations, it is an annual requirement, subject to strict penalties if not filed. However, corporations have no obligation to publish or distribute their tax returns to the shareholders.

The revenue and expenses claimed in all the forms of business operations will typically be much the same, but Canada Revenue Agency (CRA) rules for expenses may lead to some differences between net income on the income statement (profit and loss statement) and taxable income on the income tax return. These are beyond the scope of this chapter, but one distinction that is worthy of exploration is the difference between depreciation expense and capital cost allowance (CCA).

Capital Cost Allowance vs. Depreciation

Earlier in this chapter, we saw how depreciation expense is used to account for depreciation of capital assets, accounting for the wear and tear and reduced usefulness over time. For income tax purposes, depreciation is calculated using Capital Cost Allowance (CCA), and is the only method allowed by Canada Revenue Agency (CRA).

In producing financial statements, accountants can choose among several methods of depreciation, the most common being straight-line and declining balance. The optimal method will match the cost of the asset over its useful life. Straight-line depreciation deducts the same amount each year over the useful life of the asset. Declining balance applies a fixed rate to the undepreciated cost of an asset, resulting in a lesser amount amortized in each year as the asset ages, and thus less depreciation taken each year. CCA is based on declining balance, the only method of depreciation allowed by CRA.

Following CRA ruling, each asset is assigned to a particular class, with a specified CCA rate. There are over 40 classes, listing hundreds of assets that are required to be included in a particular class. Figure 8.8 lists sample CCA classes for various assets. Subject to certain restrictions, the amount of CCA that can be deducted from net income in a taxation year is determined by the rate for the particular CCA class and the remaining asset balance in the class or account.

FIGURE 8.8: Capital Cost Allowance Classes

Class	Types of Assets	Maximum CCA – % of Undepreciated Capital Cost
1	Most real estate buildings	4%
1	Manufacturing & processing	10%
8	Furniture, equipment not included in other classes, appliances	20%
10	Automobile or truck used for business or investment purposes	30%
12	Linen, tableware, tools, or kitchen utensils costing less than $200	100%

The CCA claimed in each year is the CCA rate multiplied by the remaining depreciable base of a property, or its undepreciated capital cost (UCC). This UCC is the remaining balance in the asset's account, or the initial cost less any CCA previously claimed. The cost of an asset is the purchase price, taxes, and any legal, accounting, engineering, installation, and other fees that are required to buy, install, or build the asset.

Further CCA rules include:

- **Pooling Assets:** If a taxpayer owns several assets of the same class, the assets are placed in a common pool, provided that the assets relate to the same business.
- **First Year CCA Claim:** Regardless of when the asset is purchased in the fiscal year, the eligible CCA deduction for the year is limited to 50% of the regular rate, as long as the asset is being used to earn income by the last day of the fiscal year.
- **Final Year Rule:** CCA cannot be claimed for an asset in the year of disposition, even if the asset is owned for the majority of the year.
- **Short Year Rule:** CCA must be prorated where a taxpayer's taxation year is less than 12 months.
- **CCA Recapture:** When a depreciable asset is sold, any CCA claimed during the holding period that does not represent an actual decline in

market value of the asset is considered to be taxable income at the time of disposition of the property.

Example: CCA Calculation for Building

Joe Gottrich purchased a building for owner-occupation for $320,000. The $320,000 purchase price is apportioned as $150,000 land (non-depreciable) and $170,000 building – a Class 1 asset with a 4% CCA rate. Note: the first year rule only allows one-half of the allowable CCA rate in the year of acquisition, so only 2% is taken. The maximum amount of CCA for the next three years would be determined using a declining balance method as follows:

Year	Remaining Depreciable Base or UCC	Rate	Maximum Claim of CCA	CCA Claimed
1	$170,000	2%	$3,400	$3,400
2	$166,600 ($170,000 – $3,400)	4%	$6,664	$6,664
3	$159,936 ($166,600 – $6,664)	4%	$6,397	$6,397
4	$153,539 ($159,936 – $6,397)	4%	$6,142	$6,142

The actual amount of CCA claimed in each year may be less than the maximum amounts listed above. In other words, even though the maximum amount claimable in Year 1 is $3,400, the owner can choose not to claim this full amount. A taxpayer is not required to claim the maximum or, for that matter, any CCA in that year. Ordinarily, a taxpayer would choose to claim as much CCA as possible, but there may be valid tax reasons not to do so. If less than the maximum amount is claimed in a year, the rules do not permit a "doubling up" of CCA in the following year (i.e., the amount foregone in the year plus the amount otherwise permitted in the following year).

Taxable Income

Taxable income is used to calculate income taxes payable to Canada Revenue Agency. Again, one key difference between the financial reports and tax return is that capital cost allowance must be used in place of depreciation expenses. Therefore, taxable income reported on the income tax return may differ from the net income on the income statement.

As noted earlier, a corporation is a legal entity that pays income tax. Proprietorships and partnerships do not pay income taxes. For a proprietor, the net income/loss from the business flows directly to the owner's personal tax return. For a partnership, the profits of the business accrue to the partners in the proportions agreed on by the partners and outlined in the partnership agreement. In the same way, the capital cost allowance deduction claimed by the partnership is allocated to the individual partners. The partners use these amounts in calculating their personal taxable income.

JG Corporation's Income Statement at year-end (Figure 8.4) shows a net income figure before taxes of $15,297. However, this includes $15,000 in depreciation expense, which is not allowed on the income tax return – instead, the maximum allowable CCA of $6,664 must be used. If JG Corporation pays taxes at a rate of 15% on its taxable income, then the income tax calculation for the corporation would be as follows:

Net income before taxes	$15,297
+ Depreciation expense	15,000
= Net income before taxes and before depreciation	$30,297
– Capital cost allowance	(6,664)
= Taxable income	$23,633
× Tax rate (15%)	0.15
= Income taxes payable	$3,545

The income tax payable and the after-tax net income would then be transferred to the year-end balance sheet.

Joe Gottrich, Proprietor does not complete a business income tax return, but Joe can account for this in a similar manner on his personal tax return. Joe would include the following in his personal income tax return calculations:

Net income before taxes	$15,297
+ Depreciation expense	15,000
= Net income before taxes and before depreciation	$30,297
– Capital cost allowance	(6,664)
= Taxable income	$23,633
× Tax rate (22%)[1]	0.22
= Income taxes payable	$5,199

The net income after depreciation on Joe's income statement (Figure 8.3) is $15,297, but for taxation purposes, he will have to report and pay tax on income of $23,633. Note that in calculating straight-line depreciation for the income statement, Joe's accountant was able to make a subjective choice on the estimated life and salvage value. This subjectivity makes it possible to manipulate the accounts for tax benefits – hence why CRA only allows CCA, which has a set rate.

CCA's Potential Tax Shelter Benefits

CCA allows Joe to write-off just over $6,000 per year for the next three years, with a declining deduction each year until he eventually sells the building. If Joe's personal tax rate is 45%, this CCA deduction saves him approximately $2,700 in income tax payable.

Now consider that Joe's building is in a great location where real estate values are rising quickly at 5-10% per year. Joe is making a "paper gain" on this building and will realize the actual capital gain upon sale. However, at the same time, he is benefiting by paying less taxes for its supposed depreciation in value. The key point here is that the CCA deduction is a non-cash expense, meaning he gets the taxable deduction this year, but did not have to spend any money this year for it.

If Joe eventually sells the building at a profit, CCA recapture rules mean he must repay all CCA deductions that did not truly represent depreciation of the asset. However, he still gains two benefits:

- deferring taxes, as paying later versus immediately is preferable; and
- paying taxes in future deflated dollars (e.g., $1 today will be worth a lot less 30 years from now).

Consider if this was instead a high-rise office building, with the figures involved having three or more additional zeroes – you can see that this would potentially be a massive tax benefit.

This non-cash tax deduction is the primary basis for tax sheltering in real estate, as the buyer can deduct a set percent per year for an asset that may not actually decline in value this quickly. As well, the government may periodically decide to revise these tax rules to stimulate investment in a sector. For example, they may increase the rate for multi-family housing from 4% to 5%, or give advantageous terms to film production or wine making industries. In this way, tax policy can be a tool to promote demand. When it comes to commercial real estate investment, tax matters!

ANALYZING FINANCIAL STATEMENTS

Financial statements are an important and useful way to examine the health, success, and anticipated future performance of a business. An owner or accountant can complete this analysis using generally accepted financial ratios, industry benchmarks, and analysis tools. The role of these ratios and analysis tools is to summarize detailed financial information so that it is more easily understood. In short, it can help users of the financial statements reach conclusions on:

- the level of activity and profitability of the enterprise;
- the adequacy of the capitalization – whether more investment of either equity or debt is required;
- whether the business is carrying excessive amounts of current assets (e.g., inventory);
- whether the business is carrying excessive debt relative to earnings, or if there is an opportunity to increase debt to fund business expansion; and

- the sufficiency of *working capital*.

working capital
the capital used in a business's day-to-day trading operations

Ratios are also helpful in comparing the liquidity, profitability, activity, and debt of one enterprise with a competitor in the same industry. The analysis of financial reports is beyond the scope of this course. However, for purposes of providing context, the profitability measures are worth exploring briefly. The profitability of a business is typically measured by comparing income or cash flow against the firm's assets or equity. By dividing an income measure by the investment amount, you obtain the owner's percentage rate of return. This can then be compared to the rate of return earned by other similar businesses or against the investor's required investment yield. These rates of return measures will be explored in much greater detail in Chapter 17, as this income/value relationship forms the basis for the valuation of commercial real estate.

CONCLUSION

Mortgage brokers may be involved in a transaction where the sale of a business involves real property. Given this, they are expected to be familiar with financial reports: how they are prepared, what they tell us (and what they do not), and how they may vary for different forms of organizations.

The material in this chapter has identified the high degree of comparability between accounting statements used for sole proprietorships, partnerships, and corporations, and also noted the major differences. The statements illustrated represent those used by business enterprises and, together, they are designed to summarize the financial well-being of the enterprise.

Financial statements tell a story: they provide either a snapshot of the enterprise at a specific date or show the long-term progress of the enterprise by charting a series of ratios over time. The analysis of financial statements, although beyond the scope of this course, highlights the relative strength and condition of a business in comparison to other competing businesses. This is essentially what the appraiser does in determining and comparing the market value of an investment in the income approach to appraisal, a topic covered later in the book.

Mortgage brokers are not expected to be financial analysts or business experts. This chapter provides the basic foundations only, to a level of familiarity, not expertise. In a complex situation, the assistance of a professional accountant is recommended.

1 Note that the 22% personal tax rate used in this example is higher than the 15% corporate flat tax. Personal tax rates are determined by the income earned in that period and are usually higher than the flat rate that corporations pay.