



11 Critical Mistakes Many Entrepreneurs Make

Chances are YOU may be making one of them...

Costing you Thousands of dollars NOW... and maybe even your Business tomorrow!

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This E-Book was created and authored by Paul Morin and Cheryl Turner, inspired by Hugh Tafel. It identifies 11 mistakes commonly made by many business owners, and how these mistakes often lead to loss of money or sadly, a complete loss of business.

Mistake #1 - Pulling money out of the corporation without any regard to the tax implications

In a corporation there are 3 ways of getting money out of your corporation:

Salary

Dividend

Borrowing

Many owners feel that they can simply borrow money from their corporation without realizing that money needs to be paid back within a year. Due to the necessity of paying back that money within that year, if the funds cannot be repaid – the amounts will need to be disclosed on your personal income tax return. That could potentially put you in a serious position of a huge tax liability. This is why it is important to know up front what the tax implications are so you can ensure you have the cash flow set aside for your personal income tax as well as the corporate tax.

Owners often pay themselves before they have actually mapped out what the tax liabilities are with the compensation method. In other words, they have not planned ahead. You must decide in advance whether the compensation will be reported as a wage, or should it be declared as a dividend? If the owner does not think about how the cash withdrawals should be handled, then they could be stuck with a huge tax bill at the end of the year. Also, depending on how it was set up, or improperly set up - there could be penalties as well.

Mistake #2 - Misclassification of an employee as an independent contractor

Sometimes a small business owner will hire help and they make an arrangement with that individual. At times, the arrangement is to avoid a payroll because the source deductions associated with payroll can be costly. The business owner goes ahead and hires the new worker as a subcontractor. There are specific rules that determine whether you have a subcontractor relationship, or an employee-employer relationship. If you don't adhere to the CRA's protocols and if it is

discovered by the CRA that you are not compliant, there could be penalties in the event of a payroll audit. All too often, the business owner is paying an employee when they think they are classified as a subcontractor. This could result in significant penalties down the road.

Often we encounter these types of situations in the construction industry. The business owner require help occasionally, so they may bring in a friend or an individual to help them with a specific job and it's determined that this individual will be working on subcontract basis and that individual is expected to pay their own personal tax from those earnings at the end of the year. If there's ever a problem where that subcontractor does not report the tax to the CRA, this could now become a problem for the business owner that hired the temporary worker. The government will go back the whole year and do an audit on CPP and EI contributions. This can become very costly to the business owner. It is my experience that payroll audits are very common.

Bottom line, it's very tempting and very common to simply have a subcontract relationship because an invoice is presented and a cheque is issued with no regard for EI, CPP or income tax calculations. It's quick and easy. However, all the risk of this relationship lies squarely on the business owner.

Mistake #3 - Improper use of or the setup of an automobile within a business

Often, there is the improper use of or the setup of an automobile within a business and all the rules associated with automobile compliance. What comes to mind right off the top is an individual having a company car or company truck to conduct business, but the company doesn't own the vehicle. Instead, it's been set up as an asset of the corporation but it hasn't been sold to the company. Also, there are rarely log books tracking business versus personal mileage. In addition to this, there's rarely a personal income tax benefit prepared on a T-form. Because the vehicle has not been set up properly for business, this also negatively impacts your automobile insurance. Automobiles are the second most complex thing to deal with as a small business owner. You need to make sure that you

have it properly set up and in compliance with the rules that the CRA (Canada Revenue Agency) has associated with automobiles.

As tax payers, we all need an automobile to use for getting to and from work and in the case of the small business owner they also need an automobile to conduct business. What's important to the CRA is that this automobile has been set up in your corporation, and that you are properly deducting the expense that is related to the business and not the personal portion. It is unacceptable to the CRA to purchase an automobile under our business name and use it for personal purposes and expect to have a tax deduction. What makes this so complex is that we need to make sure that all the rules that are set forth by the CRA are being followed so that we are taking the proper amount of tax deductions for the business portion of our automobiles.

If the company vehicle is not set up properly, that benefit ends up having to be taxed more basically as potential income that the owner didn't declare. Conversely, it may be that the vehicle was over claimed as an expense.

For example, a realtor uses their automobile for work – it's an expensive expense – they're all over the city, they're visiting clients, it's expected that a realtor needs an automobile to conduct their business. These are usually expensive vehicles and they put on a large amount of business mileage. If an official log hasn't been prepared to indicate business kilometers, and the CRA does an audit, how will the realtor prove what the business percentage versus the personal percent is? Without the log, the CRA may simply deny the expense and what's important is that the CRA doesn't look at things six months after a return is filed, it could be three years after the return is filed. That means three years of automobile expenses that are being questioned are possibly denied. This could be a real expensive mistake so it's just a simple aspect of making sure that you're recording correctly what is business versus what is personal mileage.

With the case of the corporation it's the same sort of issue, but there's different classifications and how we depreciate it. I can go on and on, but it's one of the first things that are picked up in an audit, even the payroll audit. The CRA will check to see the shareholder benefit on the personal use of automobiles, the

business use and the personal portion of the automobile. This is why it is so important to have all the checks and balances in place, because if you don't follow the rules, these could become costly mistakes and oversights.

Mistake #4 - Not monitoring your gross margin

One of the most serious mistakes that a business owner can make is not monitoring gross margin. And why is monitoring gross margin important? Let's share an example. Let's say you operate a retail store. More specifically, a clothing store, and you are so busy working in the business that you haven't made time to monitor your gross margin. I define gross margin this way; it is your gross profit which is your revenue less the expense to deliver your products or service, that expense would be the cost of clothing in this example and the profit associated. Your revenue less the cost of the clothing will be your gross margin. If you're not monitoring your gross margin on a regular basis, you could be losing a lot of profit within the business. If you see an accountant only once a year (at the end of your year), the margin problem may not be discovered until its too late, if at all. Some business owners wait a few months after the year end to have their corporate reports and returns processed which compounds the problem. As an accountant who is passionate about your corporate success, I urge you to seek regular council with an accounting professional. An accountant that specializes in small business accounting with a professional designation. Why do businesses lose profit margin without realizing it immediately? It could be because of price increases from your suppliers, it could be because of exchange rates, it could be because of theft of inventory. There are a myriad of reasons that would cause your margins to drop. If you're monitoring it after the fact it's too late to correct it. If you're waiting until the end of the year and you've found you had a 10% drop in margin, then it's a serious mistake, and a lost source of revenue.

So, for business owners it's crucial that they have a system in place to be able to determine if they're maintaining their margins on a regular basis. The suggested regular basis is at least monthly, a regular review so that you know that you are not losing margin and you're able to intervene to be able to correct that issue in a timely manner.

Often business owners come in with a few years to do at the same time. Many times when I get these types of books, business clients weren't paying attention to their gross margin and at the end of the year, or after a few years, they finally get their statements and realize they just lost a huge source of revenue money. This could have a dire consequence to your business.

Mistake #5 - Running your business without a financial plan or any regards for your cash flow

Small business entrepreneurs should be forward thinking. This is really a good way for business owners to plan what their break-even points are. It's not having a financial plan that can catch you when you least expect it. One example that immediately comes to mind is when owners are selling inventory in a bad economy. Sales are starting to decrease; the suppliers are starting to get nervous due to a number of the retailers taking longer to pay for the merchandise. The owner's cash flow is affected because it's all tied up in receivables, or all your cash could be tied up in inventory due to slower sales. Not being able to correctly project for soft economies can have a negative impact on future business planning. It also may impact your bank rating, or harm any chance you have of obtaining a line of credit to fund some of your receivables or inventory when you're in the weakest position possible.

There is a lot to be said about the old saying "Cash is King". The example I'll use here is Amazon.com which ran losses for years, yet they were able to stay in business because they kept growing their sales by reinventing themselves. Their sales were from direct customers who were paying upfront and then Amazon was paying their suppliers with extended payment terms. Amazon likely had 30, 60, and 90 days, dating or more before they paid their invoice. Amazon was able to fund their losses just by the sales they were generating upfront. They also planned for the future by selling shares as they grew too. Obviously if their revenue had taken a downward spiral for any length of time, they would have closed the doors a long time ago.

Cash flow is almost more important than profitability. It's seemingly important, but profitable businesses can go out of business if they don't manage their cash flow with wise forecasts and projections.

Most entrepreneurs that I talk to are planning ahead, especially those business owners that have peak periods throughout their fiscal year. If you can get this plan on paper, it's easier to see where you're going to have your issues. It's the best thing for an entrepreneur to have this document in front of them. By doing this simple step, you could potentially circumvent any potential future issues well in advance.

All business owners need a forecast in advance. Plan to have sales at a given level as well as the collect rate of your receivables. Paying your suppliers in a timely manner needs to be factored in as well. Plus, you will have business expenses such as employee salaries, et al. There is a lot to consider ensuring that you have a profitable cash flow that is always fluid within the business.

In the worst case scenario, businesses can run out of cash, even if they have a profitable venture on paper. Sales are slow and they may be faced with having to refinance the business due to tough times. If you have been responsible with your financial planning, you're in a position of strength which will ultimately make it much easier to approach a bank or a financial institution.

Mistake #6 - Looking at your cheque book to determine or estimate your tax liability at the end of the year

Small business owners that say I have no cash in the bank, therefore I shouldn't have any taxes to pay at the end of the year, are incorrect in that assumption. That's really the wrong way of assessing your tax liability. Your money could be tied up in receivables or in inventory. It doesn't necessarily have to be in the bank in order for you to have tax liabilities. There is a lot to consider when determining your tax liability at the end of the year and it isn't just based on how much money you have collected, or based on your bank balance.

This ties into mistake #1. You could be withdrawing money out of the business for yourself resulting in a low cheque book balance. I have seen this many times,

where the business was profitable and once your year end has been processed, you come to find out that you do owe money to the CRA. If a business owner in this type of situation would have been seeing a professional accountant, he would've been advised to set aside finances each month or quarter to be able to pay the tax bill.

Mistake #7 - Having an incorrect business entity or improperly setting it up

It is imperative to structure your business correctly to ensure you are getting the biggest benefit, both personally and corporately speaking. I absolutely agree that it is very important for a business owner to have a relationship with a corporate lawyer, but equally important, is to have a relationship with a professional accountant, someone who understands the complexities of small business. I advise our clients from an accounting perspective, but there are many times that I share with the client it is crucial that they get the legal perspective also. The following is an example of why this is so important;

if an individual has set up their company as a sole proprietorship and the company is generating a significant income as a sole proprietor, they are not able to use a tax deferral based on the company structure. However, if this same company was set up as a corporation, and they were making that same significant income, now the business owner has the option to pay themselves a reasonable income and the rest of the revenue is sheltered within the company.

Another example of an entrepreneur that owns a corporation is they are not yet showing a profit. In this type of situation there's really no tax advantage when it's losing money year after year. Without professional advice, some business owners just don't know when it is the right time to incorporate. It is critical to the future success of the business that the business owner discusses this with both an accounting professional, as well as a legal professional.

I advise my clients that if they don't have a corporation setup properly/legally, there may be a concern that the corporation is not protecting them from a possible future liability.

Mistake #8 - Shareholder loans and payments/loans to family members

Pulling money out of the corporation as mentioned before, can possibly cause a tax issue. The first issue being if you pull money out of your corporation you need to pay it back within the year. It's considered a loan until it's paid back. I've seen all kinds of deals where perhaps a shareholder will try to get an agreement together that they borrowed X amount of dollars to buy a cabin at the lake, and they basically setup a formal agreement between themselves and their corporation for that loan, but really, at the end of the day, it's a shareholder loan. That loan needs to be paid back within the year or otherwise it's included in your personal, taxable income. Once that's included in your personal income, then as you know you could likely have taxes due and it may not be the perfect time to have that income at your personal income tax return. So we need to be mindful of the money we pull out of our corporations. That's the same whether it's to us, to our spouse, or to our family members. It's all considered the same: a loan is a loan.

The principal shareholder can't do an agreement to lend himself personally from his company money that's payable back over a certain period of time. There are some exceptions, but they are rare. With regards to purchasing a treasury stock or buying a home, generally if you can borrow money from your corporation as an employee then you need to open that up to the rest of your employees. That's basically how you would be able to do it, but it's not very often that you give your employees whatever type of loans that they need.

The CRA representative will deem that in most cases that it is income in the hands of the receiver, the owner, or basically the shareholder. I see this with business owners all the time. Shareholder loans must be paid back with after tax money. You need to pay the tax on that money in order to pay back your shareholder's loan. So it can be a costly venture, depending on the dollars involved, but it's good to have a plan when we're taking money out of our business all year long.

Mistake #9 - Corporate funds to fund personal expenses. Mixing personal expenses with business expenses

I often see a shareholder using corporate funds to fund personal expenses. - Mixing personal expenses with business expenses makes things very complicated. We all know that we never want to report a personal expense as a business expense, because the repercussions are huge. There are significant penalties on that, but using the corporate checkbook or using the corporate bank account as a personal bank account also is very risky. Not only are you not having that separation from the corporate bank and your personal banking, but it becomes public record. The CRA is able to look at your personal expenditures. You also will pay more fees in bookkeeping and accounting to make sure that none of these personal expenses have been included on your financial statements or on your tax return. When the CRA sees these personal expenditures, they are inclined to view it suspiciously too. Also, they will dig a little deeper just to make sure that there are no personal expenses on your tax return. It's just good practice to have that separation.

Mistakes can happen too, especially if something's misclassified. A good example would be a trip to Costco to get office supplies and something's thrown on there that's personal. Come time to do the books at year end, it's forgotten to separate personal from business. In the event of an audit, and this is caught, then everything is suspiciously looked at with the CRA. These kinds of mistakes are totally avoidable. If and when you are audited, (which is more often than people think), you don't want to raise red flags that will cause the CRA to be suspicious. If your books are really kept clean, and everything is logical, they will be out of your office in no time. Bottom line, less stress for you. I encourage you to do all that you can to ensure that the audit is efficient and with as little disruption to your business as possible. You need to be focused on your business and clients, not focused on the CRA and the issues that they're demanding.

Mistake #10 - Not using a professional to do your bookkeeping and preparing your income tax return

Not using a professional to do your bookkeeping and preparing your income tax return is a common mistake. When there are mistakes, when there are issues such as the previous Costco example, it could potentially be a real mess at the end of the year. I always view your books and records as a means to help you run your business better. Without good information, you can't move forward in a positive, well informed way. You can't use the information that your bookkeeping system generates (your income, your expenses, and your assets, liabilities) to base decisions on in the future if they are full of mistakes.

Many entrepreneurs of small to mid size businesses may be more wary than they should be of hiring professional help early in their business because they view this as an unnecessary expense. One that they can't afford right now. With all of the previous listed mistakes that we've gone through, I am sure that you now see that you can't afford to not have an accountant. You need a trusted advisor to make sure that you're avoiding all kinds of possible mistakes and penalties and huge disruptions in your business. To be set up for success in business, you can plan ahead, which will help you to better manage, forecast and put together more solid plans to grow your business with proper records.

Mistake #11 – Not meeting your tax deadlines

It's important that you keep good records that actually reflect your taxable income and really be diligent with compliance. You need to be sure to meet the tax deadlines; you're filing, reporting your GST, and reporting your taxable income properly and accurately. In the long run, this will save you a lot of money.

Sometimes we run into issues with the cash flow as a small business owner, we may not have the tax money available for whatever reason but we always need to ensure that we file on time and that we file accurately. This saves you failure to file penalties. Filing on time is good business practice. If you are without funds to address your tax liability on the filing date, this issue can be discussed with your accountant. They will be able to help you create a payment strategy that will make sense to the CRA.

There it is: 11 key business mistakes I have observed many small business owners make. I have mentored, coached, and continue to work with hundreds of business owners every year.

11 key mistakes from Paul Morin, PBA. We are passionate about the success of small business. We hope you find this guide very useful and we wish you the best of success in your business venture!