

Where did the profit go?

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This is a typical scenario at the accountant's office: the year-end accounts are presented, there's no money in the bank, there's nothing extra to reward the owners for their effort throughout the year, but there's a tax bill to pay. How can this happen?

Essentially, there are several broad reasons why this happens:

- Lock up: work has been done and expenditure incurred in producing that work, but the customer hasn't paid. There's still profit though, and the tax man will want his bit.
- Income has been spent on capital items (assets like plant, equipment etc) which are not immediately tax deductible. The tax deduction occurs as depreciation, which in the first year might only be 10 to 20 per cent of the amount spent. If these items are bought with profits, although the cash profit has gone on buying the equipment, that profit will also be taxed, and the cash to pay it will have to come from elsewhere.

Example: a machine is bought with cash for \$10,000. The company tax on the income generated to produce the \$10,000 will be \$3000, but the tax reduction

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because of the depreciation on that machine will only be about \$300. So the \$10,000 cash profit is gone, and there's \$2700 to find to pay the tax.

■ In a similar fashion, although equipment can be financed, the loan repayments can still exceed the tax deductions available from the depreciation allowance on the equipment. Big ticket equipment operators like forestry contractors suffer this. Forestry machinery is usually heavily financed, and payable over up to five years. But the tax deductibility of the item will typically be spread over about 10 years. This means that these poor guys (and girls) may have to make good profits just to pay tax, even before they get anything to live on.

Pity the poor farmer, who often pays tax on increases in the value of livestock before he's even raised any cash from the sale of them.

■ Failure to provide tax on the drawings that are taken throughout the year.

There can be good reasons why these conditions exist, but good management is required to prepare for the cash flow and tax consequences. It is critical that business owners and directors get a good handle on where the cash goes, and it should not be left until the year-end accounting exercise is done.

Your accountant does not work for the IRD: they work for your business, and should be a part of the solution to the problem by working to devise strategies and forecasts to improve cash flow and taxation management.

In a perverse way, tax is a good thing: it means that your business is profitable, and profitable businesses need a tax payment plan to provide for anticipated taxation payments.

It is also our job to ensure that the amount of tax you pay is kept to a minimum by ensuring that you claim for everything you are entitled to, and that your affairs are arranged tax efficiently.

Watch for our next business seminar: Where did the profit go?

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