

the bottom line

Welcome to the spring edition of "the bottom line", our accounting and taxation newsletter. This edition deals with Financing in the Current Economic Climate and News in Brief.

FINANCING IN THE CURRENT ECONOMIC CLIMATE

Obtaining and securing the right finance can be extremely difficult for small and medium sized enterprises (SME's) particularly as it is not always clear what type of finance is appropriate.

There are credit constraints faced by SME's trying to access finance, particularly in an economic downturn. A business might be better suited to incur debt or to sell equity. It is particularly important to be aware of the sources of finance available in difficult market conditions.

DEBT FINANCE

Bank overdrafts and loans

Authorised overdrafts are appropriate for day to day borrowing to meet short term cashflow deficits. Where possible they should not be meeting permanent financing needs e.g. the business cashflows should at some stage become neutral or positive. Loans tend to be used for longer term financing. The loan terms can be matched to suit the business needs, repayments can be planned and budgeted for, and costs are generally lower than for overdrafts.

The main advantages of overdrafts are:

- Easier to arrange than a loan;
- More flexible. Charges and interest only arise on funds needed;
- Regularly reviewed.

The main disadvantages of overdrafts are:

- Repayable on demand;
- Interest rates generally higher than for loans;
- Exceeding overdrafts can result in significant penalties and higher interest rates;
- Security is often required.

The main disadvantages of loans are:

- Generally you need a financial track record for banks to lend to businesses;
- There can be penalties for early redemption and they are not as flexible as overdrafts;
- If cashflow is seasonal regular repayments can cause problems;
- Security or personal guarantees are generally required.

In order to obtain a loan or overdraft the lender will require evidence that the business will be able to fund repayments and work within limits and covenants

imposed. A comprehensive business plan will be needed showing evidence of a successful track record and ability to repay finance. Security may be needed by way of a charge over business assets or if these are insufficient, personal guarantees may need to be given by the directors.

Bank charges vary widely as do arrangement fees. Some charge a fixed fee; some charges are on a transactional basis.

Alternative lenders

There are several specialist lenders that provide an alternative to traditional banks and building societies. All have very specific criteria and are available to certain restricted individuals. These can include:

Credit unions; Islamic finance; The Prince's Trust; Co-operative and Community finance and Community Development Finance Institutions.

Unauthorised lenders, aside from friends and family, should be avoided as costs are generally much higher and terms and conditions more onerous.

Asset finance

This can take the form of a commercial mortgage over a business property or leasing or hire purchase agreements over other assets used in the business such as plant and machinery, office equipment or vehicles. It is necessary to weigh up the costs of such finance against the tax advantages often associated with purchasing an asset outright. In addition, where an asset is leased, the lease agreement can cover maintenance costs or can be akin to an operating lease when the asset is not required for long periods of time. This can give greater flexibility particularly where asset development is fast moving. Leases and hire purchase agreements give certainty of repayments and interest charges are allowable for tax purposes. The costs of the rental payments are generally allowed for tax purposes although often in the form of equivalent depreciation payments where the lease is considered to be a finance lease. Assets acquired under commercial mortgages, finance leases and hire purchase agreements are capitalised on the balance sheet and provision is made for the associated creditor. Assets acquired under operating leases are not treated as assets of the business and are not shown on the balance sheet.

Debt factoring and invoice discounting

These sources of finance are often provided by the banks as well as other more specialist financial institutions and are used to raise capital against unpaid invoices. They are only available to businesses that provide credit to other business due to provision of services or sales of products. With debt factoring invoices are sold on and monies are paid in advance to the business by the factoring company of approximately 85% of the debt. The balance less charges is then paid once the customer pays. The factoring company controls the sales ledger and deals with credit control. The business often still runs the risk of bad debts and if a customer does not pay the business will have to repay the factor. With invoice discounting the business retains control of the sales ledger and debt collection.

Some factors also provide export factoring in respect of overseas debts which can greatly assist with credit control in the overseas jurisdiction. The currency in which the debt is recovered should be carefully considered as it may be worthwhile protecting yourself against exchange rate fluctuations.

Supplier finance

Some finance companies will provide finance against agreed debts, settling the invoice within agreed terms, with the customer being allowed a period of time to pay, with interest. The debt is based on the suppliers' credit history.

Enterprise Finance Guarantee (EFG)

In January 2009 the government introduced support up to £1.3 billion of bank loans to companies with turnover of up to £25m. The EFG will be available up to March 2010.



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EFG is available to viable credit-worthy businesses without collateral and/or track record. Qualifying business can borrow between £1,000 and £1m repayable over a period of up to 10 years. The Government will guarantee 75% of the lenders' exposure on individual qualifying loans to qualifying small businesses in the UK. In addition to regular repayments of capital interest, there is a 2% annual premium, although in the current climate, for 2009 this has been discounted to 1.5%. There are detailed guidelines on eligible businesses which must be considered.

EQUITY FINANCE

Equity finance involves the raising of capital from an investor in returning for giving away a share in the business. Before seeking equity finance you should prepare a business plan incorporating realistic financial projections, a detailed marketing plan and what an investor can expect in return.

The main advantages to equity finance are:

- The funding is committed to the business. Investors only realise their investment on sale;
- The external investors may be able to bring valuable skills, contacts and experience to the business;
- The external investors have a vested interest in helping the business to become successful;
- Generally investors are interested in capital growth rather than income from dividends allowing the business to reinvest excess profits in order to further grow the business;
- Further funding may be provided as the business grows.

The main disadvantages are:

- The owners share in the business will be diluted;
- Potential investors will require considerable background information which can be extremely time consuming to provide;
- The external investor will generally require some input or control over the management of the business and its strategy;
- The legal issues associated with raising equity finance can be complex and result in considerable added costs.

Business Angels

Business angels are individuals who invest in high growth businesses in return for equity. They are usually prepared to invest in businesses at an early stage of

development or the expansion of established businesses. They may be prepared to invest in higher risk projects provided there is potential for substantial rewards. Many business angels bring valuable experience and skills to a business. As they generally act in isolation (although some do operate via a syndicate), they have the ability to make fast investment decisions without the need to refer to a committee. It can be difficult however to find a suitable investor to match your business needs and the skills required.

Venture capital

Venture capitalists generally invest larger sums in return for requiring a substantial share in a business. They will often require services or products to be unique with the potential for high returns. They generally require proven track records and will not consider start up businesses. They tend not to get involved in the day to day running of the business but will help with developing the strategy of the business. Costs associated with venture capital funding can be substantial and may be incurred even if the investment does not proceed.

Enterprise Capital Funds (ECF's)

ECF's were established by the Government in 2006 and so far have committed £161m to ECF funding. A further £120m has been earmarked for further funds to 2012. ECF's invest a mix of public and private money in small high growth businesses that are seeking equity finance of up to £2m. The Government provides up to two thirds of the capital in each ECF in return for a preferred return on investment at or close to gilt rate, together with a limited share in the profits of the fund in order to encourage private investors to participate where they would not otherwise.

Capital for Enterprise Fund

This £75m fund was launched in January 2009 and is targeted at SME's. It operates by providing investments of between £250,000 and £2million to UK businesses that are unable to obtain traditional finance. They are available to businesses falling within the Companies Act definition of medium sized. The funds can be used to pay off existing debt to free up capital for day to day cashflow and for

investment for the future. The businesses will be managed by professional fund managers who are appointed by Capital for Enterprise Limited.

Enterprise Investment Scheme (EIS)

The EIS aims to attract investors to smaller high risk trading companies by offering a range of tax benefits to investors who purchase shares in those companies. Potential tax benefits for individuals include:

- Income tax relief at 20% on investment into eligible shares;
- Exemption from capital Gains tax when the shares are sold;
- Deferral of capital gains tax on the disposal of other assets;
- An option to offset any loss on disposal against capital gains or income; and
- Exemption from inheritance tax after holding the shares for two years.

Venture Capital Trust Scheme (VCT's)

This scheme allows the investment by individuals through a corporate vehicle similar to an investment trust. Investment in any tax year is limited to £200,000 and to qualify for full relief shares must be held for five years from issue by the VCT. Potential tax benefits for individuals include:

- Tax rebate of 30% of the amount invested, subject to the overall tax liability for the year;
- Exemption from capital gains tax on disposal; and
- Exemption from income tax on dividends and distributions from a VCT.

Other funding

Grants may be available of up to £500,000 to help businesses and individuals research and develop innovative products, services and processes and to support business investment or job creation projects.

As can be seen there are considerable resources available; the difficulty is in securing them by justifying a need for the finance coupled with an ability to service the debt or grow the investment. If you require any assistance with raising funds, either via debt or equity please contact us.

NEWS IN BRIEF Employment Act 2008

The Employment Act 2008 comes into force on 6 April 2009 and results in changes to the Disciplinary and Dismissal procedures (DDP) and Grievance procedures (GP) adopted by an employer. There is a new

statutory code of practice which replaces the mandatory 3 step procedure as set out in the Employment Act 2002 of Action and invitation to meeting, Meeting and Appeal. The new code of practice does not apply to redundancy dismissals or non-renewal of fixed term contracts.

Failure to comply with the code of practice can affect the quantum of damages awarded by an Employment tribunal. The tribunal has the power to increase awards by up to 25% if an employer has not complied with the code.

Contacts:

For further information about the issues raised in this newsletter or if you would like to find out about the range of services that we can offer, please contact Stephen Dabby, Morisha Christy, Tony Sian, Nick Nicolaou or Alex Green.