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Debt restructurings and changing
lending conditions for SMEs 1

Companies Act 2006: Further
Update 4

Going concern for small
companies 5

Tax treatment of redundancy
payments 6

What goes up ... can't necessarily
be paid out 7

Sector spotlight on the
Recruitment industry 7

Goodwill in Trade Related
Properties 9

Are you directing your debits? 10



Editor's comment

This edition covers a number of issues faced by many businesses in the economic downturn. In our lead article, we look at corporate lending in the current climate and particularly the challenges faced by businesses seeking to restructure their finances and debt obligations. While the current economic climate is of course challenging, there are steps that business owners can take to place themselves on a firmer footing.

On the tax front, we look at the treatment of redundancy payments and the treatment by HMRC of 'free goodwill' in trade-related properties. We also continue to provide a reminder of the deadlines for the implementation of Companies Act measures.

Accounting and reporting developments included this month cover the impact of increasing discount rates on pension liabilities and guidance on 'going concern' issues. Finally, we conclude by providing some tips that may help ensure your online banking processes remain within your control.

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Debt restructurings *and changing lending conditions for SMEs*

01

The impact of the UK's banking crisis and tightening credit conditions is of course being felt by companies of all sizes. In this article, we look at the lending criteria being employed by debt financiers, and some of the ways in which owner-managers may be able to put themselves on the front foot in dealing with their debt obligations and potential financial restructuring.

Current conditions

The tightening lending criteria of the UK's banking system are reflected in recent market research. The Bank of England's Credit Conditions Survey shows that corporate credit availability continued to tighten at the very end of 2008, with further reductions in supply expected.

Furthermore, the decreasing rate of credit availability was greater than expected, and was mainly due to factors such as declining loan approval rates and increased collateral requirements on the part of lenders. Dynamics such as the changing cost and availability of funding, changing perceptions of risk in certain sectors and falls in the value of commercial property (which has the effect of reducing the usefulness of property as collateral for lending) were also cited as being among the factors affecting the lending appetite of Britain's banks at the year's end.

However, the overall picture is perhaps not one solely of gloom. The British Bankers Association's 'small business' statistics indicated in January that small business lending rates may be improving (albeit marginally), and by the end of 2008, month-end term

lending had increased and was around 9% higher than the average for 2007. In addition, average monthly growth rates in term lending were higher in 2008 than in 2007. All sectors were showing a growth in lending, with the exception of construction, hotels & restaurants.

Lending expectations and changing criteria

How has the downturn affected the lending criteria for SMEs? We have noted that with appetites for risk considerably reduced, target gearing levels are much lower than has been the case for some time. EBITDA¹ to debt ratios that bankers apply when lending to SMEs have typically been reduced from 3-4 times (and formerly often much higher) to 2½-3 times – and possibly lower in many cases.

In sectors that have been particularly adversely affected by the downturn, gearing ratios can be expected to see further reductions. Debt providers are looking to match debt to trading levels, are assessing balance sheets very carefully, and are generally looking for conservative balance sheet management when assessing applications for lending or extensions of credit.

¹ EBITDA: earnings before interest, tax, depreciation and amortisation.

Here, owner-managers can expect their lenders to request far more specific questions as to exactly what they are being asked to help fund. And in particular, cash is being regarded as a very favourable asset to have on business balance sheets.

Debt relationships: the lender's perspective

In the current environment, an appreciation of the position of the lender is likely to be very useful. Unlike equity investors, a debt provider will typically have no representation on a company's board of directors, and therefore limited visibility over the business's progress and financial position.

This state of affairs of course presents few problems when trading and re-payment proceeds as planned. However, with little board-level influence or control, lenders are reliant on information provided by management, and their knowledge of the business is subject to a time-lag behind that of the Board.

If problems look likely to arise, the lender's concern is to have as much advance knowledge as possible – an outlook that can sometimes be at odds with the temptation of equity-holders to delay relaying bad news in the hope for an improvement. This potential conflict can create huge tension between lenders and equity-holders, and can result in valuable time being lost that could otherwise be

used to find potential solutions to the problems facing the business.

Also, the contractual triggers commonly used by lenders assume the timely and accurate supply of information by management, and a failure to meet this obligation will have an adverse and serious effect on the credibility of management.

This not only sours the relationship between a businesses and its lender, but also decreases the extent to which the lender may be willing to work with management to assist with its problems through solutions such as debt restructuring. This is why, despite the downside risk of payment enforcement it is generally advisable to keep your lender informed of your situation at all times.

Debt restructuring

From the automotive industry to property and private equity, deteriorating trading conditions over the past few months have seen a number of high-profile businesses seek to restructure their finances and debt obligations.

But for those experiencing trading difficulties or financial distress, debt restructuring is also an option potentially available to SMEs. This typically involving a reduction of debt and a lengthening of the business's payment terms; debt restructuring may be a solution that, as well as affording valuable 'breathing space', offers the lender a means of recovering their money at a premium over the longer-term.

The restructuring of corporate debt in this way can involve negotiation on a wide range of issues, beyond simply the question of extended payments and payment terms.

Owner-managers in a debt restructuring situation should expect their business to be the subject of a thorough assessment by the lender in a number of areas. Management, for



example, is a key area – the lender will evaluate aspects such as the quality and integrity of the management team and the strength of the relationship that the lender has with them.

The inherent value in the business will also be assessed, with the lender likely to be assessing whether ‘real’ value still exists in the business, whether its business plan is sensible and still attainable, and ultimately whether a realistic prospect still exists of their interest and capital being repaid at a future date.

If there are other creditors, the lender is also likely to consult and act in concert with them, as without their agreement and participation a restructuring solution may well prove to be untenable.



03

The positive thing to note here is that, from a bank’s perspective, there are often advantages to restructuring a company’s debt, rather than forcing it into an insolvency process. Firstly, this course of action may offer the lender a better chance of a positive outcome than that presented by insolvency – particularly in times of recession, when even well run businesses often find their plans adversely affected by wider macro economic factors.

Secondly, there may be opportunities for the lender to negotiate better terms and maybe to cover risk by taking greater security over assets or increase fee income (sometimes depending on future performance), through the use of upside rewards such as equity warrants. The wider potential disadvantages to the lender when insolvency occurs, such as the cost in terms of adverse publicity and wider supply-chain failure, are also not to be discounted.

Housekeeping

Good financial housekeeping is of course a good defence against difficult trading conditions, and adopting a proactive approach towards meeting lending concerns can only be a positive

move. There are some potentially simple, but very effective steps that can be taken which can help put you on the front foot when it comes to dealing with your lenders.

For example, you could take a closer interest in your lending covenants: do you really know them, and are you meeting them? You could also devote more time to cash flow forecasting. Are you in danger of missing payments to key suppliers? If so, it may be a good idea to flag this up at as early a stage as you can and negotiate if at all possible. Similarly, let your bank know of problems in advance wherever you can.

The importance of essentially simple measures such as paying close attention to your management information and monitoring your creditors should not be underestimated.

As well as compiling regular, detailed summaries on your cash position, it is good practice to look carefully at your customers. Tight credit control means making sure you firmly apply the payment terms that your customers have agreed to.

These and other aspects of good financial ‘housekeeping’ will help put you more firmly in control of both your debt and your cash – an important line of defence against restructurings that, while sometimes necessary, are of course very unwelcome and potentially expensive.

Conclusion

While conflicting views exist as to whether the UK has endured the worst of the recession, or whether an extended economic slump is more likely, it is clear that the practices and assurances required by lenders’ have undergone change that is likely to be long-lasting.

By arming themselves with an understanding of lenders’ rationales, focussing on their financial housekeeping and maybe looking at measures such as hedging their risk or building up their network of professional advisers and contacts, owner-managers can improve their ability to cope with recession, and hopefully emerge from it in a position of strength.

Companies Act 2006 Further Update

Already the Companies Act 2006, in 2009, sounds like yesterday's news, but its phased introduction means that we will need reminders of its effects for some time yet.

The new rules regarding reports and accounts took effect, mostly, for accounting periods beginning on or after 6 April 2008 and will therefore be having a practical impact very soon.

The key changes worth noting by private company owners/directors are:

The accounts filing deadline has been reduced to 9 months

Unless you relish the thought of discussing final changes to the accounts with the auditors over mince pies, it is probably worth clarifying accounts approval deadlines now.

This shortening of the deadline has also been given added spice by the recent announcement by Companies House of significantly increased penalties for late filing. The penalties take effect from 1 February 2009. They do not affect accounts that have already been filed (on time), but that are being amended. However, they take immediate effect for any accounts which were late on 1 February. The penalties are outlined in table 1.

Directors cannot approve accounts unless they give a true and fair view

This has been given an added dimension since the published accounts watchdog, the Financial Reporting Review Panel, confirmed it would be examining accounts filed at Companies House which carry a qualified audit report. Although the FRRP's focus is unlikely to be on private company accounts, business owners/directors should be made aware that a risk of FRRP inspection exists if they file accounts which don't give a true and fair view.

This will affect, for example, companies that choose not to hold investment properties at market valuation as required by SSAP19, possibly to avoid the valuation costs. Holding such properties at valuation may take the company over the threshold for a medium sized company. This, in turn, would result in a need for a Business Review in the Directors Report.

The thresholds have been changed as set out in table 2 below.

Medium-sized groups will be required to file group accounts

Only small groups will continue to be exempt. Preparation of group accounts for the first time needs careful planning to ensure that all the relevant information for disclosures and consolidation adjustments is available at the right time and that reporting deadlines can be met.

Turnover must be disclosed in the abbreviated accounts of medium-sized companies, which render abbreviated accounts for these companies almost pointless. Business owners might like to consider whether it is worth the extra time and cost to prepare them.

04

Table 1 penalties for late filing of accounts

How late are the accounts delivered ?	Penalty Private Company
Not more than one month	£150
More than one month but not more than three months	£375
More than three months but not more than six months	£750
More than six months	£1500

Table 2 new company size thresholds

Small	Medium
Turnover £6.5m	Turnover £25.9m
Balance sheet £3.26m	Balance sheet £12.9m
Employees 50	Employees 250

Going Concern for Small Companies

Small company owners who are managing to run successful businesses in the current economic environment will still find themselves having to support their assessment of their business as a going concern.

Directors of smaller companies must, under the Companies Act 2006, prepare annual accounts that give a true and fair view. In doing so, directors must decide if the going concern basis of preparation can be used.

Whilst smaller companies will not always have an audit, their accounts may still be needed by their bank, suppliers and customers.

If a business applies the FRSE, the accounting standard applicable to the smallest companies, its directors will be required to:

- assess whether the use of the going concern basis of accounting is appropriate, and
- to disclose any material uncertainties they have in the accounts.

Guidance has been published by the Financial Reporting Council for directors of smaller companies which helps identify procedures that can be used to support conclusions on going concern, and sets out some useful disclosures.

The guidance is useful for any director, whether in the position of leading a thriving business or a struggling one, as it sets out sensible disciplines for maintaining good control over a business's financial position. It includes:

- Procedures for deciding whether steps are needed to address potential problems with future

income, costs or cashflow – this includes preparing forecasts for a period of at least 12 months from the date of approval of the accounts.

- A suggestion that directors might find it useful to summarise the key conditions contained in existing bank or supplier arrangements, and consider how changes in income or cashflow might affect those arrangements e.g. will future income levels produce the interest cover required by a bank loan covenant?
- Suggesting a meeting or discussion with the company's bank to assess the likelihood that loans and other funding agreements will be renewed.

Having gathered this information, the directors should then be in a position to assess whether there are material uncertainties which need disclosure in their accounts.

If there are material uncertainties, and suitable disclosure is made in the full accounts for shareholders, it is worth noting that specific disclosure must also appear in the abbreviated accounts filed at Companies House.

The full guidance: *An update for directors of companies that adopt the Financial Reporting Standard For Smaller Entities (FRSE): Going concern and financial reporting*, can be found on the Financial Reporting Council's website at <http://www.frc.org.uk>



Tax Treatment of Redundancy Payments

Every day now seems to bring news of employers laying off staff. Where termination payments are made it is important for employers to be aware of their correct treatment for taxation purposes.

There is a general perception that payments on redundancy can be made tax free but that is only partly correct. Redundancy packages (indeed termination payments in general) are often computed by reference to a number of factors and a termination payment may, on close analysis, consist of various elements, some of which may be tax free and some not. For some time, HM Revenue & Customs (HMRC) has focused on termination payments with a view to identifying any potentially taxable elements.

When considering to what extent a termination package may be taxable, HMRC's approach is first to distinguish payments which arise only as a result of the termination of an employment from payments which arise from the employment itself.

Genuine redundancy payments and compensation for loss of office will generally only be taxable to the extent they exceed £30,000. On the other hand, if a termination package includes amounts which can be seen to have arisen from the exercise of the employment, those amounts will be fully taxable.

Examples of such payments might include accrued bonus entitlements, holiday pay and any payments, including severance payments, which are specifically provided for in the employment contract. Also, if an individual employee is paid consideration for entering into restrictive covenants on his departure, such payments are fully taxable.

One area which can sometimes cause difficulty is the making of payments in lieu of notice (PILONs). Where an employment contract gives the employer the option to make a PILON to an employee instead of giving the notice that would otherwise be due under the terms of that contract, any

such PILON will be fully taxable. On the other hand, if an employment contract simply provides for a notice period to be given and the employer fails to give that notice of termination, that failure is a breach of contract. Any PILON made in those circumstances is arguably compensation which will only be taxable to the extent it exceeds £30,000.

However, HMRC is known quite frequently to argue that where an employer habitually makes PILONs rather than allowing employees to work their notice period, such PILONs are to be regarded as arising from the employment relationship rather than from the failure to give due notice. That line of argument is questionable and should normally be resisted.

Where a termination includes a taxable element, it is the responsibility of the employer to deduct tax under the PAYE system as appropriate. If HMRC discovers that PAYE has not been applied correctly, it will turn first to the employer to recover tax that should have been deducted at source.

National Insurance contributions will also be payable through the PAYE system in respect of any taxable amounts that can be said to arise from the employment rather than from its termination. Interest and penalties will be levied in respect of amounts which have not properly been accounted for through PAYE.

Given that HMRC frequently review termination arrangements in order to ensure that they have been treated properly, it is important for employers to ensure that such payments are properly and appropriately documented in order to minimise the risk of potential future problems.



What goes up ... can't necessarily be paid out

The current economic environment is lending an Alice in Wonderland like quality to financial matters, and not least of these is pension scheme valuations.

Under the accounting rules of FRS17, defined benefit scheme pension liabilities are discounted using a rate based on high quality corporate bond yields – typically the bonds need to be AA rated.

As bond prices have fallen, yields have moved in the opposite direction and consequently the discount rates used in valuing the liabilities have increased.

This has the effect of reducing the valuation of pension scheme liabilities.

In some schemes, although the same economic conditions have reduced the value of the scheme assets as well, the value of the scheme liabilities has fallen to such an extent as to create a surplus.

However, all is not what it seems. The surplus is created by accounting rules and does not necessarily represent a figure realisable in cash.

Under accounting rules, the business is only able to recognise the surplus on the balance sheet if it is in a

position to recover it either through a reduction in future contributions or refunds from the scheme ie only if it actually represents a future net positive cash inflow.

When bond prices recover (leading to a fall in yields and therefore increase in pension liabilities), the reverse situation may occur. If scheme asset values don't rise to the same extent as bond prices do, a deficit will arise, even though it may appear as if the economy is recovering.

Curiouser and curiouser...

07

Sector Spotlight *on the Recruitment Industry*

Our firm's Professional & Consultancy Services Group has recently published the results of an online survey of UK recruitment agencies. Carried out at the end of 2008 as the country moved officially into recession, it covered areas such as respondents' growth expectations and strategies and their methods of financing, as well as their thoughts on diversification and other areas of business planning.

Emerging from the downturn

The survey is entitled 'Recruitment Business Survey: Surviving and Emerging from the Downturn'. Among its key findings are that at least half of senior recruiters expect to restructure their business as a result of the economic slowdown. In the survey, 55% of respondents stated that they expect the economic downturn to lead

them into operational restructuring, while 20% said that they expected some degree of financial restructuring to be necessary.

This indicates that the ongoing impact of the 'credit crunch' is encouraging a wide re-evaluation by recruiters of their company's areas of business and their financial arrangements.

In order to meet the challenges of the downturn, recruiters see movement into new sectors and UK geographic regions as areas of potential growth, and indeed, a significant proportion (54%) of respondents are confident of being able to increase their business's turnover in 2008/09.

Despite the gloomy economic outlook, almost two in five (40%) of respondents still expect to increase overall profitability in 2009, perhaps

reflecting the entrepreneurial and positive nature of recruiters, and a better outlook in some specialised sectors such as natural resources and the public sector.

The survey also revealed that recruiters expect permanent placements to be affected by the downturn, with only a small number of respondents – 23% – expecting to see growth in this area. Respondents were more positive about prospects for the temporary placements market, with more than half expecting to see growth here in the current and next financial year. Indeed, 51% of people said that their margin on temporary placements currently remained unchanged from the previous financial year.

Overall, while participants in the survey are understandably nervous about how the economic climate will affect



them, the research shows that many are wisely planning how they will meet the challenges that current and future conditions present.

Planning and tactics

Widespread consolidation among SME recruiters does not appear to be on the cards, with only 3% of respondents expecting growth stating that they are planning for growth to be achieved through acquisition during this year or the next.

In terms of financing their businesses, invoice discounting appears to be by far the most common source of external funding used by recruiters, with 41% of recruiters using this as a principal form of financing. Interestingly, almost 40% of respondents said that their business is self-funded, even for working capital.

Threats and challenges

Recruiters unsurprisingly saw the economic downturn (cited by 83% of respondents) as the greatest threat to their business, followed by the prospect of reduced margins and intensified competition. Greater availability of candidates was seen as the biggest opportunity (being cited by 80% of respondents) for recruiters in the near term.

A surprisingly high proportion of recruiters (84%) do not expect to be affected by withdrawal of the staff hire concession (announced in the last Budget) that from 1 April 2009 compels them to charge VAT on the full cost of hired staff, rather than just the commission or fee charged by the agency. The e-survey was carried out among decision-makers in small and medium-sized business with turnover chiefly of less than £15 million, with more than 70 people from UK-based businesses participating.

Martin Holden, Head of our Professional & Consultancy Services Group, comments on the survey's findings: "Recruiters know the advantages of being lean and flexible in their approach, but even in tough times opportunities can emerge, and many owner-managers appear to be aware of this also," he says. By resisting the temptation simply to 'batten down the hatches', businesses can maintain and even improve their operational position in a downturn, and many are confident of emerging from the downturn in a stronger position than they entered."

If you would like to see a copy of the survey please contact your usual client partner or contact your nearest Saffery Champness office.

Goodwill in Trade Related Properties

HM Revenue & Customs has recently changed its opinion regarding 'free goodwill' applying to the sale of businesses where trading is carried on from trade related properties.

When buying or selling a business, the allocation of consideration between assets can have significant tax implications.

In the past, HMRC's view has been that it was unlikely that there would be 'goodwill' of any significant value in businesses such as public houses, hotels, petrol filling stations, cinemas, restaurants or care homes, where the occupation and use of the particular, specially adapted, premises was essential and integral to the generation of the business income. Such businesses were usually considered to be largely or wholly incapable of being sold separately from the property they occupied.

HMRC now acknowledge that when such businesses are sold as a going concern the sale price will reflect the combined value of the tangible assets together with the benefit of other business assets including 'free goodwill' – such as contracts, staff, suppliers, records of previous customers and other intangibles.

Greater value may be realised by combining tangible and other business assets for sale as a going concern than by selling assets separately.

In apportioning consideration to goodwill, purchasers may benefit from the tax relief on the amortisation of purchased goodwill that was introduced by Finance Act 2002. Savings in stamp duty may also be achieved as goodwill is not subject to stamp duty unlike property which is liable to stamp duty land tax.

Sellers of long established businesses may benefit from the ability to offset a March 1982 value against the consideration attributed to goodwill and, where the goodwill was acquired after the Finance Act 2002, sellers may benefit from the ability to offset brought forward trading losses against profits on its disposal.

There may also be implications for both purchaser and seller if either is seeking to claim reinvestment relief. The allocation of consideration will be a matter for negotiation between the parties and subject to possible review by HMRC.

HMRC's practice note, issued on 29 January, explains how one should go about apportioning the price paid for a business as a going concern between goodwill and other assets involved in the sale. The practice note can be read at: <http://www.hmrc.gov.uk/svd/practice-note.pdf>



Are you directing your debits? the risks with electronic banking

As if we needed telling, a recent survey by UK payments association Apacs has indicated that the use of the cheque continues to decline year on year, whilst the use of online banking continues to rise.

Whilst online banking converts cannot imagine operating without this facility, the use of online banking raises specific challenges for controlling business accounts.

Whilst some smaller businesses might be tempted to use a personal online banking facility for business purposes, this is not advisable.

Business online banking systems are designed to deal with the risks present in a business environment. A key control in a traditional paper based banking system would be the business owner signing the cheques or direct debit mandates.

However, with online banking this important control is often unwittingly removed when access to the online payment facility, is delegated to another person.

A key control in setting up a business online banking system, and one which helps to replicate the traditional physical signing control, is to create a fixed list of payees. The list should only contain the details of regular business suppliers and other payees as approved by the business owner/



director. Access to change the list should be strictly limited to the business owner/director and changes should be reviewed regularly. This ensures that the person who in practice makes the online payments, can only advance monies to the pre-set list of payees, and cannot set up additional payees themselves.

Shift in burden of proof

It is especially important to have such a control in place (among others), as online banking carries a further

additional risk for a business; for electronic banking services the bank will only compensate the business for losses if the directors can show that the bank has been negligent.

This is a switch from the position with traditional banking arrangements, under which the bank will make good a loss to a business if the bank debits a forged cheque or instruction, unless the bank can prove that the account holder was negligent.

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