Understanding Financial Control

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Context and Content

- Early-stage, entrepreneurial businesses
- Topics covered:-
  - Structure and start-up
  - A little on funding and budgeting
  - Record-keeping
  - Compliance
  - Reporting
  - Throughout, some discussion of tax!

Is it really a Business?

- If all you have is:-
  - A piece of technology, or
  - A single product
- ...then it might be better to licence it!
- Avoids the need for infrastructure, HR, finance, logistics, supply chain, compliance, hassle....
- Instead....

Licence Deal

- Just lie on the beach and collect the royalties!

Two Types of Enterprise

- Supplying goods and/or services from day one, or
- Undertaking some form of research or development in anticipation of later revenues from goods and services
- Many similarities
- A few differences, particularly in the area of funding

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Business Vehicles

- Limited company
  - Almost always the right choice
- Unincorporated business
  - Sole trader or partnership
  - Sometimes right if small/simple/low-risk
- LLP (limited liability partnership)
  - Useful in certain specific situations
- Other specialist entities

Get it Right at the Start!

- When setting up a company...
- ...get the shareholding structure right at the beginning...
- ...as it is difficult to change later!

Order of Share Issue

- A new research company is formed
- Business Angel funding is raised
  - Say £1m for 25% of the company
- Then shares are issued to one of the academics
  - Say 10% of the shares at par
- Academic joins the board

Wrong Order!

- 25% for £1m means a valuation of £4m
- Academic has received 10% for a negligible sum
- Shares worth £400,000
- Tax bill of 50% of £400,000. i.e. £200,000
- Plus (perhaps) NI at 12.8%
- But the academic has received no cash
- More of this later...

More Wrong Order!

- Once value has built up in a company
  - IP transferred in/protected/created; or
  - Profits being made, or
  - A funding round
- Any transfers of those shares could cause
  - A capital gains tax problem for the transferor
  - An income tax problem for the transferee
- Into the right hands before value builds

Budgets

- You need projections in your business plan
  - Broad brush, medium term
- You need an operating budget
  - Short-term, more detailed
  - To compare performance when under way
- These budgets must be consistent
- Both built up from the same data and the same assumptions

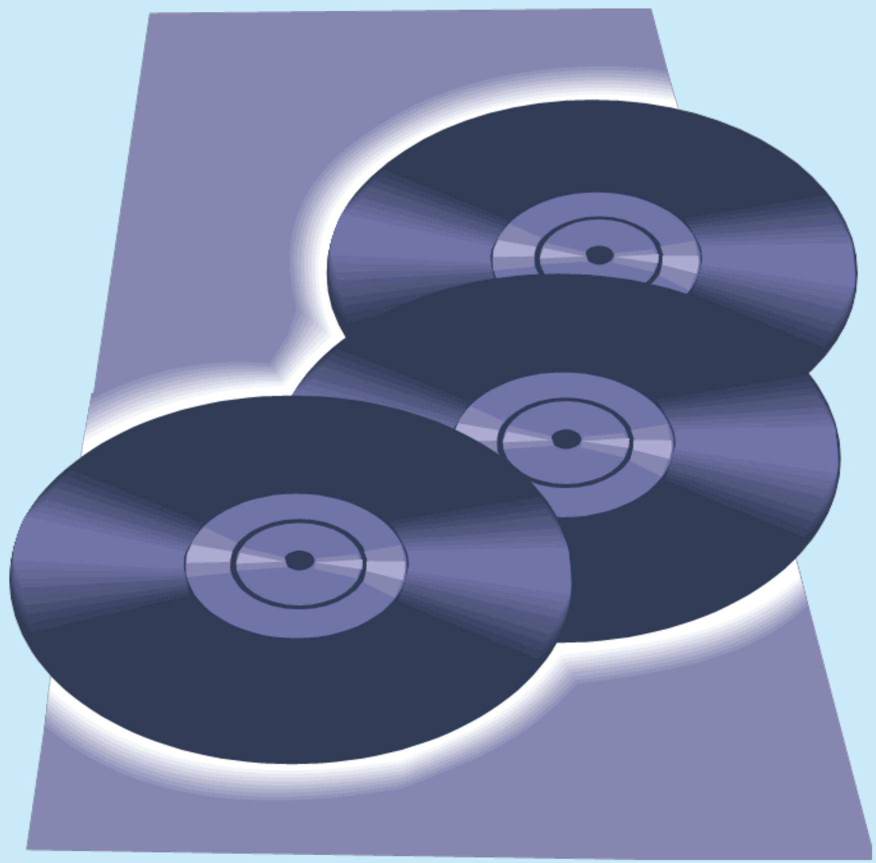
Funding

- Pre-revenue enterprises
  - Require equity funding
- Revenue-generating enterprises
  - Might not need any funding
  - Could use debt or equity
- Either way, external funding can often create additional financial constraints and responsibilities

Initial Compliance

- Register with HMRC (x 3)
  - For corporation tax (or income tax if operating as a sole trader, partnership or LLP)
  - For VAT, assuming you need to be registered
    - Turnover above £73,000 and...
    - ...not making exclusively exempt supplies
  - For PAYE
    - Even if you have no employees to start with
    - Because PAYE invariably applies to every director

Record Keeping



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Bookkeeping

- Not the same thing as accountancy
- Data capture and recording
- Needs painstaking accuracy
- Implement systems of checks and controls
- Basis for compliance, reporting, planning and many other vital functions
- Evolves over the life of an enterprise

Financial Records

- The “Books”
- Used for compliance
- Used for reporting
  - Reports used for planning, monitoring etc
  - Management reporting
  - Financial reporting
- Management must be involved in ensuring recording is sound

Accounting

- Why so complicated and mysterious?
- Surely profit equals money in minus money out?
- Why debit and credit? Plus and minus should be fine!

Main Reports

Profit and Loss Account

- All revenue **earned** (not received), less...
- ...all costs **incurred** (not paid)...
- ...to arrive at profit...
- ...for the **period**
- **Result for the period**

Balance Sheet

- All **assets** (physical or otherwise), less...
- ...all **liabilities**...
- ...to arrive at **"net worth"**...
- ...at the balance sheet **date**
- **Snapshot at a particular date**

An Example

- A business buys 100 widgets at £1 each for cash (Cash out = £100)
- It sells those widgets for £2.50 each (Cash in = £250)
- Profit at the end of the month is £150
- Same as increase in cash
- There, I told you so!

Another Example

- A business buys 100 widgets at £1 each for cash (Cash out = £100)
- It sells 100 widgets at £2.75 each on 60-day credit to a sound customer (No cash)
- Cash basis - £100 loss for the month!
- Proper "accruals" basis says profit of £175
- Match costs when incurred with revenue when earned

One More Example

- A business buys 1,000 widgets at £1 each for cash (Cash out = £1,000)
- It sells 100 widgets at £3.15 each for cash (Cash in £315)
- Cash basis: Loss for the month £685
- Proper basis: Profit of £215...
- And £900 of stock held at the month-end

Debits and Credits

- “Positive” bank balance is an asset
- “Positive” supplier’s balance is a liability
- Signs are opposite
  - By convention the first is a debit, the second a credit
- Similarly “sales” and “cost of sales”
  - Positive sales is a credit
  - Positive cost of sales is a debit

Accounts Preparation

- To get from “raw data” to “useful information”
  - To get from “books” to “accounts”
- Lots of changes, even from perfect books
  - Non-cash and non-paper transactions
    - Stock movement
    - Depreciation
  - Accruals and prepayments

Who Uses Accounts

Management Accounts

- Management!
- Investors (shareholders)
- Lenders (banks)
- Potential acquirers
- Anyone you want to allow to see them

Financial Statements

- External regulators
  - HMRC
  - Companies House
- Shareholders
- Customers
- Suppliers
- Competitors!!
  - Keep disclosure to a minimum
- Employees
- Anyone at all!!

Management Information

- Often will include accounts
  - Profit and loss account
  - Balance sheet
- Comparison with budget
  - Or with last year
  - Variance analysis
- Other key performance indicators
  - Suited specifically to the business

Key Performance Indicators

- Selected or designed to suit the specific business and circumstances
- For example, in a recruitment agency:
  - Number of temps at clients
- In a distribution business:
  - Stock turnover days (a financial ratio)
- In web marketing business
  - Number of hits to client sites

Management Information

- Management must:-
  - Understand…
  - Have confidence in…
  - Review…
  - Meet and discuss…
- …management information
- Unwillingness to do so is courting failure
- Involve **all** management – it isn't "someone else's problem"

Management Accounts

- Other uses:-
  - Reporting to non-management shareholders
  - Reporting to lenders
  - Showing to potential providers of finance
- Can be any frequency as appropriate
  - Often monthly or quarterly
  - Sometimes half-yearly
- Management accounts add credibility

Cash is King

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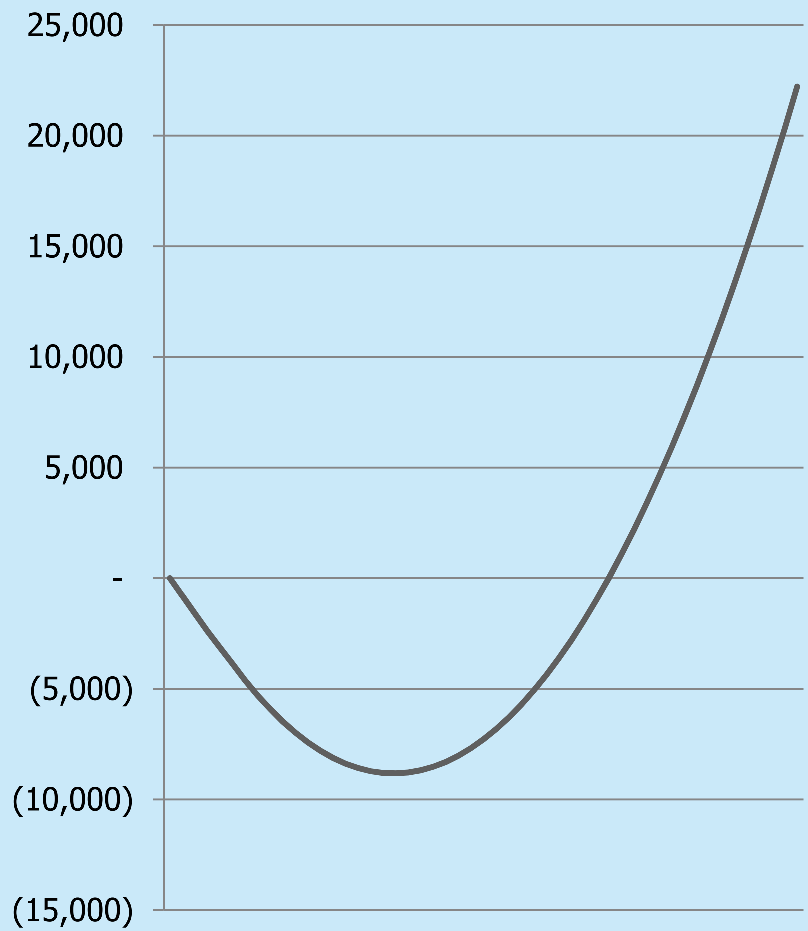
Cash Balance



- "Hockey Stick" curve
- Typical of early-stage, high growth companies
- Depth of trough is sensitive to "slippage"
- Vital to ensure that there is a Plan B

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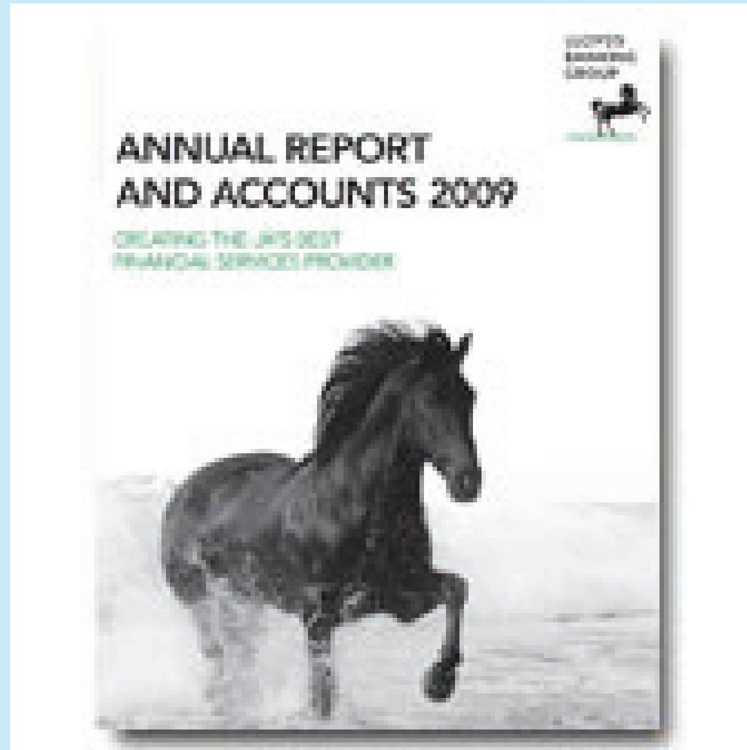
Cash Management

- Running out of cash is unforgivable...
- ...and usually terminal!
- So careful monitoring and planning are essential
- Calculate "cash burn" – particularly important for pre-revenue stage

Financial Reporting

- Generally, annual accounts
- Prepared for shareholders...
- ...by the directors!
- The responsibility of the directors...
- ...even if they are audited!



Reporting Framework

- Statutory – Companies Act 2006
  - "True and Fair View"
- Accounting Standards
- Includes notes; lots of disclosures
- Audit?
  - Many small companies exempt
  - Debate about value added if optional

Financial Statements

- Long-winded way of saying “Accounts”
- Used to determine corporation tax
  - Submit with CT return to HMRC
- File at Companies House
  - May file abbreviated accounts...
  - ...provided certain conditions met
- But full accounts still needed for members (i.e. shareholders) and HMRC

Reward

- How do entrepreneurs get rewarded?
  - Salary/dividend
  - Exit
- Consideration of reward for key employees etc

Dividends and Salaries

- Dividends are very tax-efficient
  - But can only be paid out profits
  - To all the shareholders
  - In their shareholding ratios
  - Suit profitable owner-managed businesses
- Salaries can be paid
  - Out of pre-revenue companies
  - Without regard to shareholding ratios

Directors on the Payroll

- Pay to directors should go through PAYE
- Almost no exceptions
- "Self-employed" directors – doesn't work
- "Non-exec" status doesn't help either
- If the director operates through own limited company...
  - ...then can be paid gross, but...
  - ...problem just moves, because of IR35!

Employment Status

- When engaging a "self-employed" person
- Consider the terms (contractual/actual)
  - Too much like employment....
  - ...HMRC will ask for tax on the basis...
  - ...that the fees were the net pay, so...
  - ...they are likely to gross them up, and...
  - ...charge tax and NI on the gross amount...
  - ...and go back over six years!

Payroll

- Full of pitfalls and traps
- When it is simple, no problem
- Caught by a host of snags, including:-
  - SSP, SMP, SPP
  - Student loan deductions
  - Pensions (personal or occupational?)
  - Directors' NI
- Best to outsource to specialists

Benefits in Kind

- Rarely tax-efficient
  - HMRC are wise to that!
- Sometimes necessary to attract employees
  - Cars
  - Beneficial loans
  - Accommodation
- The one remaining tax-efficient benefit
  - Pension – soon to become compulsory!

Employee Participation (1)

- Is it a good idea to encourage employees with share ownership?
- There are two significant risks of doing so:
  - Can be very difficult to “undo”
  - High risk of tax liabilities for employee and company
- But, as a staff retention strategy, much to recommend employee participation

Employee Participation (2)

- Three reasons for owning shares:-
  1. Voting
  2. Sharing in dividends
  3. Sharing in the proceeds of sale on "exit"
- 1 is irrelevant in an SME context
- 2 can be replaced with a bonus scheme
- 3 is the one that matters, especially in the context of an equity-backed SME

Employee Participation (3)

- Tax drawbacks:
  - Issue of shares to employees...
  - ...at anything less than full market value...
  - ...is taxable on the "discount"
- How do we get employee participation in growth?
  - Without horrible tax consequences?

Employee Participation (4)

- Options – under EMI
- Enterprise Management Incentive
  - Need a set of rules which comply with law
- Granted at current market value
  - Need to negotiate a current value with HMRC
- To be exercised (usually) at exit
  - No tax on grant
  - CGT only on uplift to price at exit

Exit

- How is a business valued?
- No single, meaningful way
  - Investment (e.g. property) businesses by valuing individual properties/investments
  - Present value of future earnings stream
  - Many unknowns
- The real value is determined by...
- ...what someone will pay for it!

Due Diligence

- Your business will be examined in detail by prospective purchaser
- Financial controls and disciplines will be scrutinised
- But you will be fine...
- ...because you will have great controls!

THANK YOU

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