



**PKF**

Accountants and business advisors

Issue 9 2004

# forward focus

Building value for growing businesses

## Cashing in

Whether you're flirting with flotation or toying with retirement, see inside for different ways to unlock the value of your business.

### In this issue

Going public  
To float or not to float?

Setting up shop  
in the UK

Financial diary

Shareholder  
management for SMEs

Show me the money  
A guide to profit extraction

Making an exit  
Exiting needn't be taxing  
Exits and pensions

Disaster area!  
The top ten things NOT to do

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# Going public

## To float or not to float?

The dot.com era has a lot to answer for. Not only did it rather cynically promote the idea that floating a company was the logical step for every aspirant business, but it also created the perception that an Initial Public Offering (IPO) was the quickest way to grow a business – or exit, flush with cash.

This is an inaccurate picture. In 2000 (at the height of the “new economy”) more than 265 companies were admitted to the Alternative Investment Market (AIM). In 2003, against a more sober backdrop, only 146 new companies were admitted to the same market.

An essential difference in 2003/04 was that brokers and other advisors became more wary of companies seeking flotation as a “get rich quick” exit route for entrepreneurs. The prospect of poor share liquidity and the frequent fall in price in the after-market generated more careful reflection on the pros and cons of public company status. There was also a return to considering the fundamental attributes of the business: management, market demand, systems and controls, and competitive advantage.

With the recent announcement of a delayed introduction of International Financial Reporting Standards for AIM-listed companies, and the continuing tax reliefs available to investors, 2005 may see a further recovery of admissions over 2004 (199 in the year to 1 September).

The crucial thing to remember is that each company is different. There will be a host of factors – personal, historical and systemic – that make every business unique, so the reasons for considering a flotation will also vary.

### Why float?

Not unreasonably, the most common given reason is the need to raise capital. However, there are other potential benefits that may justify the time and expense of a flotation. Flotation improves the liquidity of a company through the injection of equity and can improve long-term financial stability. A company may find itself at a commercial disadvantage if it is not listed but most of its

competitors are (and are thus seen by customers as being more financially reliable).

A company may have a strategy of making acquisitions, in which case flotation gives it the profile to be seen as a serious contender by the vendors, while also giving it the flexibility to use shares and/or cash raised to pay for the acquisitions.

The ability to provide share ownership schemes encourages employees’ participation in the ownership of the company and increases their long-term commitment. This in turn helps the company recruit and retain good staff.

Existing shareholders, especially external investors, may be looking to realise a part of their investment in the company; so, for some, flotation will also be a welcome and managed exit route. Shareholders also gain a market for additional realisations at a later date.

If you are considering an IPO you need to think through your motivations and how these align with the market and regulatory requirements. You may also wish to take a step back and consider the various alternative ways in which you might, for instance, raise money, increase your profile or address realisation pressures from minority shareholders.

For more information about the pros, cons and mechanics of floating your company, consult PKF’s concise guide, which is available in hard or electronic format. Contact Andrew Pincott on 0207 065 0135 or email [andrew.pincott@uk.pkf.com](mailto:andrew.pincott@uk.pkf.com) for your free copy.

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# Setting up shop in the UK?

If you are based overseas, establishing your business in the UK is a major challenge. Whether you want to set up a factory network or just sell goods over the internet, you may already be aware of many potential problems – and are sure to discover many more along the way.

However, help is at hand in the form of PKF's forthcoming guide, "Doing business in the UK". From questions that may seem too simple to ask (just what exactly is the UK?) to the intricacies of personal and corporate taxation, our handy booklet gives a clear first overview of this varied and complex subject.

The different aspects of business are discussed chapter by chapter. Among the topics covered are: the UK business environment; the different types of business structure and what they mean; methods of accounting; taxation; means of securing finance; and the issues surrounding foreign personnel in the UK. You can also read up on the services PKF offers to inward investors, from auditing and advisory services to corporate recovery. The wide range of help that we can give you and our depth of knowledge of the local business environment means that, with PKF as your guide, investing in the UK is easier, safer and will give you better returns.

## Inside information

Entering a new environment can be daunting, but advice from those already on the inside can make all the difference. Here are just a few handy tips for those about to take that first step.

- *Don't bring assets and people into the UK unless they are essential; consider all the consequences of doing so.*
- *Understand the distinction between residence and domicile – it can have a significant effect on tax liabilities.*
- *Don't forget that grants and other state aid may be available.*
- *Note the differences between the UK and its offshore islands, Guernsey, Jersey and Isle of Man.*
- *Everything takes longer than you hope: be realistic when setting timetables.*

We hope that you will find our guide a solid starting point and an informative first look at this vast subject. If you would like a copy, please get in touch with your local PKF representative.

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# Financial diary

Dates for your business diary

**1 December 2004 to 31 January 2005**

**28 December 2004**

- *Private companies with 28 February 2004 year ends should file their accounts*

**29 December 2004**

- *Deadline for submission of personal tax returns using Electronic Lodgement Service if the outstanding tax may be collected via PAYE*

**30 December 2004**

- *Deadline for submission of personal tax returns using Internet if the Inland Revenue is to compute the liability or if the outstanding tax may be collected via PAYE*

**31 December 2004**

- *Public companies with 31 May 2004 year ends should file their accounts*

**19 January 2005**

- *Small employers deadline for 3rd quarter payment of PAYE/CIS*

**30 January 2005**

- *Public companies with 30 June 2004 year ends should file their accounts*

**31 January 2005**

- *Private companies with 31 March 2004 year ends should file their accounts*
- *Deadline for submission of personal tax returns – to avoid extending enquiry window.*
- *Deadline for submission of personal tax returns – to avoid potential £100 penalty (N.B. for some tax offices the deadline may be the following day).*

# Shareholder management for SMEs

Chairmen of SMEs usually have their work cut out just managing the business – never mind the shareholders! Yet this should be one of their key performance drivers. After all, if the owners of a business cannot agree on long-term strategy, how can the management team implement it?

## Shareholder Motives

Reasons for investing in a business opportunity vary enormously. Founders have developed a good business idea and want to test their judgement, hoping to provide a living for themselves and generate long-term gain as well. The management team may invest for the same reasons.

Friends and relations of the founders and the management team will invest partly to support their colleagues and partly to generate a good long-term gain (this is often proportionally greater in an SME than is available in quoted companies).

Trade investors will invest partly for a potential of capital gain, but also to help secure a trading relationship.

Business angels invest for the capital gain potential, and also because they may have business skills relevant to the investee business. They may see an opportunity to enhance that business and hence the value of their investment. Subscribing for shares can generate various tax shelter opportunities, which may be another important incentive.

Finally, professional investors (institutions and venture capitalists) are investing exclusively to generate a superior return for their investors.

## Attitudes change

It would be a mistake to assume that an investor's motives will remain static. The business evolves and may follow a different path from that envisaged at the time of the original investment. Key personnel could change, attitudes may shift and friendships with individual investors will evolve. Personnel changes alone can alter relations with investors. Finally, an investor's own circumstances can change, perhaps requiring them to convert their shares into cash when there is no ready market for unquoted shares.



So, even if there was one agreed purpose at the start, this consensus is unlikely to survive more than a few years. If shareholders' agendas start to differ widely, the chairman has to take action. Otherwise long-term strategy becomes cloudy, indecisiveness and procrastination sets in, and soon the outcome is inevitable. Competitors seize their opportunity, the business starts performing badly, and failure beckons.

## Taking action

The chairman's role is about clear communication. Good chairmen regularly communicate with their shareholders, staying aware of their attitudes and motives. The chairman then communicates these to the board, which can feed the results into its long-term strategy. But real life is rarely that simple.

Personal prejudices, or an unwillingness to create disruption, can often mask a shareholder's true feelings. This is dangerous, for if matters are not addressed early they can escalate and cause damage. It is often easier to get an unconnected party to survey the attitudes of all shareholders. This can be quite a task, especially if the business is a second or third generation business with many disparate shareholders. Because we understand these shareholder issues, PKF is well positioned to undertake this activity.

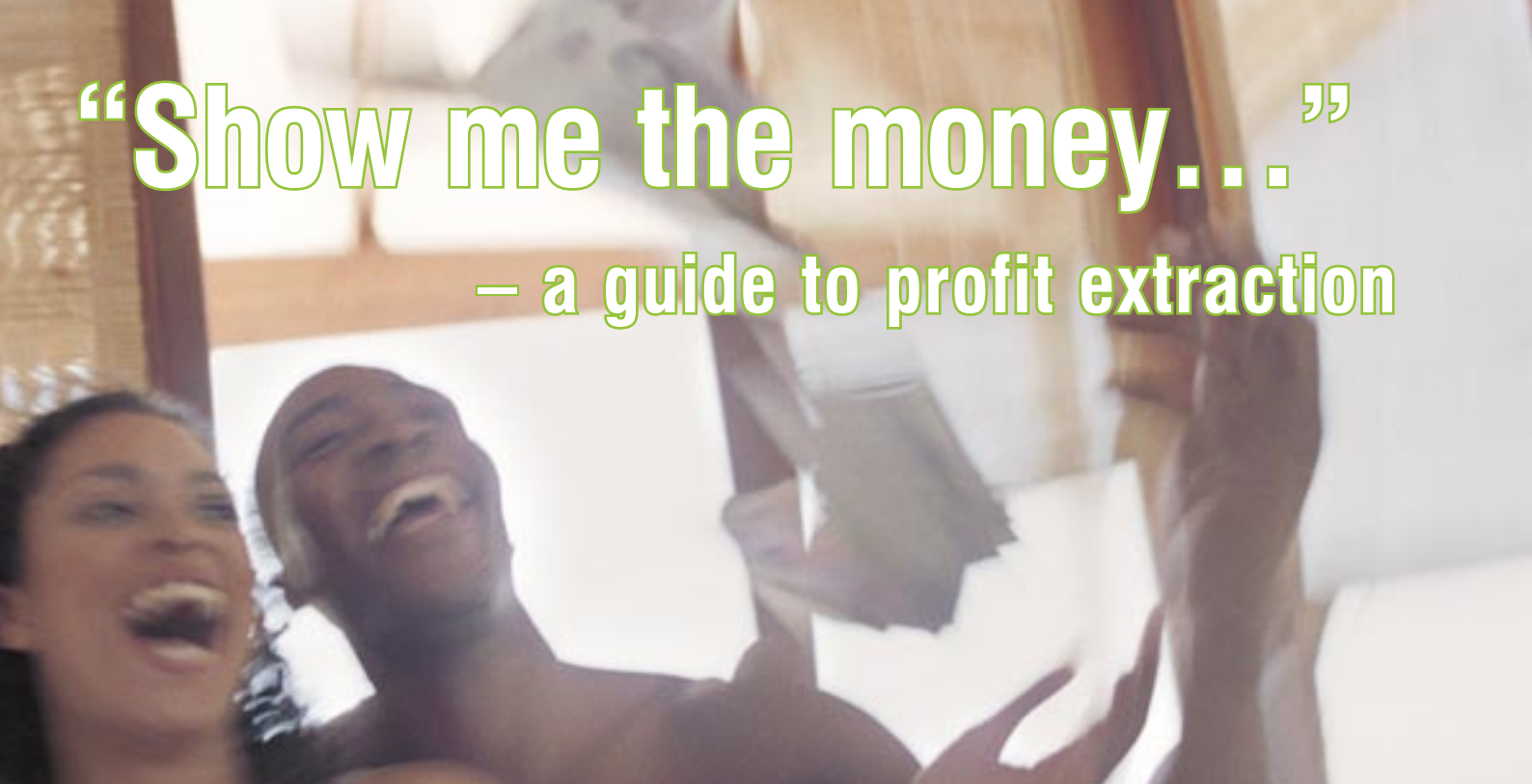
## Solving problems

There generally comes a point in a business's life when some or all of the shareholders want to exit. If everyone agrees, then all is well – the business is put up for sale or, as an interim step, floated on a stock exchange. But what happens if some shareholders want to remain and others want to go? Luckily there are several solutions, but finding the right one can be a problem in itself. The best course of action is to take independent professional advice, both from a commercial and taxation point of view, to produce and implement the best solution.

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# “Show me the money...”

## – a guide to profit extraction



When your business has matured and is finally under control, your thoughts may well turn to extracting some serious cash in return for all your hard work. You will want to make the extraction as painless as you can – in other words, do it as tax efficiently as possible. As with making an exit (see pages 6 and 7), your best options for extracting profit will depend on your individual and company circumstances. However, they could include some or all of the following.

### Salaries and bonuses

The simplest way to extract profit is to pay yourself a salary and/or bonuses. In determining the balance between salary/bonus and dividends, you should take account of the different tax consequences to both the company and you. However, if you are working full-time in the business, the minimum wage legislation must be considered, unless you are a director without a formal employment contract. Paying higher sums as salary will trigger national insurance contributions (NIC) of up to 23.8%.

### Benefits-in-kind

You should also consider taking some remuneration in the form of benefits-in-kind. A number of benefits offer NIC savings, and a few are also free of income tax (for example, a mobile phone).

### Dividends

The long-established alternative is to extract profits by way of a dividend. This is tax efficient for owners of small companies, even though the recent introduction of the non-corporate distribution rate imposes a 19% charge on the company. However, a dividend is not always the lowest cost option. For owners of single companies with taxable profits between £300,000 and £1.5m (pro-rata for groups) corporation tax relief at 32.75% on a salary or bonus payment may outweigh the advantages of a dividend payment. The Special Commissioners' decision in the recent

case of *Jones v Garnett* (Arctic Systems) cast doubt on the tax-effectiveness of some dividend policies pursued by companies owned and managed by married couples. Family companies should now take expert advice on updating their dividend policy.

### Property and loans

Holding business property outside the company can be very efficient. Rents paid by a company for use of the property qualify for corporation tax relief, but are not taxed on the owner as earnings – thus NIC is avoided. Similarly, repayments of a loan that you have made to the company do not constitute income and, therefore, are free of tax and NIC. Any interest that the company pays on the loan is taxable on the lender, but is free of NIC. Of course, it may be tax-deductible for the company.

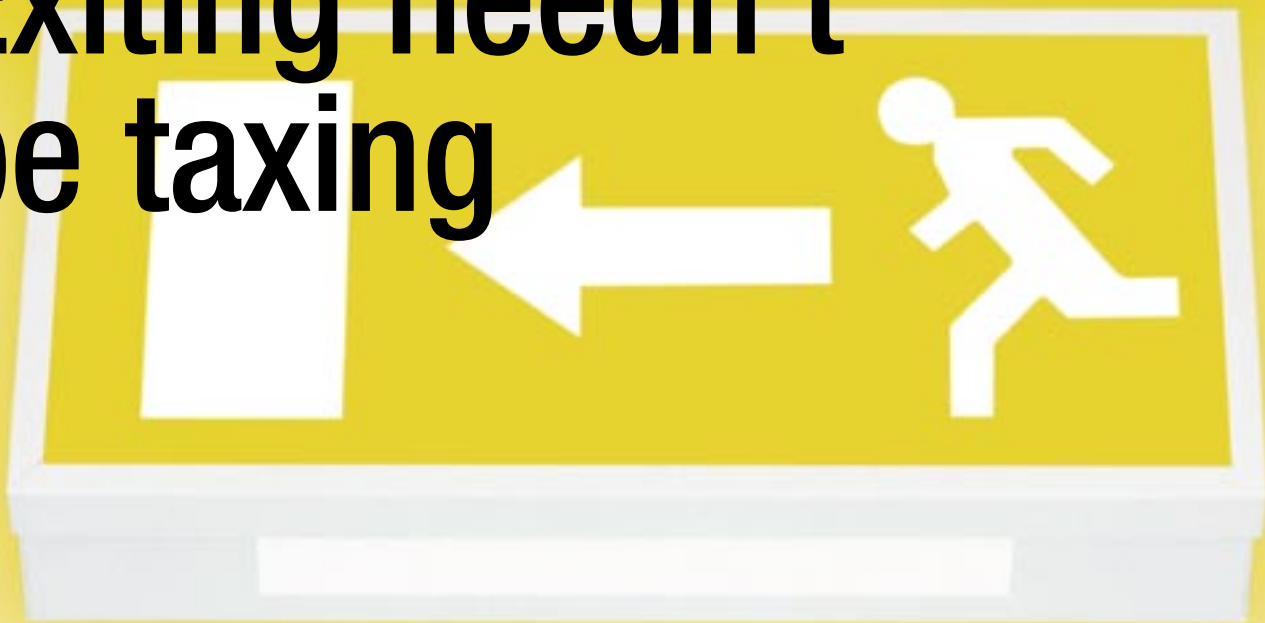
### Pensions

To be most tax efficient you should consider pension contributions. Payments made on your behalf to approved schemes qualify for corporation tax relief but trigger no income tax or NIC liability. Once in the fund, any growth in the value of the assets or income they generate is also tax free. The snag is that you cannot start to draw the cash until age 50 (rising to age 55 from 2010), so this is a rather longer-term option for many.

There are many variations on the above themes. The best route for you may not be obvious and may take some time to identify, so you should consider carefully your own circumstances and plans. PKF has considerable experience of identifying the best options for company owners. If you would like to discuss this issue further, please get in touch with your usual PKF contact.

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# Exiting needn't be taxing



When you start to plan your business exit strategy, the first step is to decide what you want to do afterwards. You may wish to retire, move on to another project, allow your children to carry on your business, or simply take a break. But what are the tax implications?

Once you know where you are going you can establish how much income and/or capital you will need to get there (it may not always be necessary or tax efficient to extract as much cash as possible immediately). Then you and your business advisors must consider your options thoroughly and determine the cost of each. You may need to change your plans if the costs are high, the timing is wrong or a buyer cannot be found.

Though there are many ways to structure your exit, they are likely to fall into one of the following three categories:

- *Sell the business lock, stock and barrel (usually by selling your shares in the company).*
- *Sell off the most valuable parts of the business and wind up the company.*
- *Hand over the running of the business to a family member but retain some financial interest.*

## **Selling the whole business**

When selling the whole business, the main tax to consider is capital gains tax. It is likely that the majority of any gain will be taxable, but business asset taper relief can substantially reduce the tax that is due. However, this is not guaranteed simply because you have run a business – there are complex qualifying rules. For example, if the value of a company's non-business assets (such as cash and property not used in the business) represents more than 20% of its value, taper relief may be restricted to the lower rates applying to non-business assets.

When selling your company you must consider what to do with surplus cash. Depending on your future plans, it may be appropriate to extract as much as you can as a dividend, arrange for the company to make large pension payments or “sell” the cash with the business. This last option may be the most tax efficient if full business asset taper relief is available, or if you are planning to invest in a new venture.

If you do not need the cash immediately, another possibility is simply to swap shares in your company for an investment in the purchasing company (in shares or loan notes), particularly if your purchaser is a large and secure company. This can give you a continuing income and make it easier for the purchaser to finance the deal. It also allows you to defer payment of tax on the capital gain. Shares or loan notes can subsequently be sold off in small numbers over a number of years to make the most of your (and your spouse's) annual capital gains exemption. The downside is that this carries commercial risks and requires formal clearance by the Inland Revenue (the Revenue is keen to ensure that such sales are not structured simply to avoid tax). Without official clearance, any capital gain may be taxed at the time of exchange.

## **Selling business assets**

The timing of asset sales can significantly affect the tax liability on the funds realised. For example, if your company is to be wound up, it may be better to sell assets before it ceases trading. If the formal liquidation procedures commence after trading has ceased, a small company is likely to become a close investment company, liable to corporation tax at the full rate of 30% on income or gains from subsequent asset sales. Short-term leaseback arrangements could allow principal assets to be sold without ceasing trading.

Of course, any sales of assets by a company could lead to corporation tax charges. Moreover, as the owner, you must pay income tax on cash extracted by way of dividend or salary, or capital

gains tax on the value of shares at the time any remaining capital is distributed on liquidation. A more tax-efficient way to extract funds is through making pension contributions, if this ties in with your plans.

And don't forget any balancing charges. These apply where trading ceases or assets (on which capital allowances have been claimed) are sold. Depending on the asset values, these can add to the taxable profits of the last trading period.

Another option is to retain a business property and sell the trade. This could allow you to retain an ongoing income from rents.

Whether you are selling assets or the whole business, you can defer capital gains tax by reinvesting the cash in another business that qualifies under the Enterprise Investment Scheme (EIS). However, you need to invest within three years of realising the gain. The deferral option is no longer available for investments in Venture Capital Trusts. If you are not taking a major stake in the

new business or are not going to be involved in running it, you can also qualify for 20% income tax relief on up to £150,000 of your EIS investment.

### **Letting the family take over**

This can be a fraught process. However, if all parties can cope with the change of responsibilities, this can be good for all concerned. Younger family members of the family get the chance to run an established business and the original owner need not trigger significant tax liabilities, because sales or gifts of shares or assets to the next generation can be phased over several years if appropriate.

Establishing your best exit route is one of the most important business decisions you will make. It requires careful planning and is likely to involve lengthy negotiations with the purchaser, as well as a hand-over period. If you would like advice on any of these issues, please get in touch with your usual PKF contact.

## **Your own golden handshake: exits and pensions**

If you are going to lay down the baton in favour of the golf club, it is never too soon to make sure your retirement funding is sorted out. Start preparing at least three years before your business exit and ask yourself these questions:

### **Is there scope to make significant pension contributions before you retire?**

If you are not providing for your pension through an occupational pension scheme, the annual limits on contributions are currently quite restrictive. However, from 2006/07 these limits will increase to 100% of your annual earnings or profits (up to a maximum of £215,000). Therefore, if you are approaching retirement, there could be advantages in delaying the happy day for a few years so that you can build up a much larger pension fund.

If you are a member of an occupational pension scheme, it may be necessary to boost your taxable salary so that large contributions can be made without the risk of over-funding. This is particularly likely to be an issue if you have been extracting profits by way of dividends rather than salary.

### **Can your company afford the contributions?**

Remember it is possible for a company to borrow in order to make pension contributions – although this will make it less attractive to a purchaser.

### **Will tax relief be available?**

Currently, it is virtually automatic for your company to be allowed a tax deduction in respect of pension contributions made for employees, although you must be aware of the contribution limits for personal pensions and the over-funding rules for occupational schemes. However, from 2006/07 the company must prove that

any contributions made are wholly and exclusively for the purpose of its business. If your disposal of the company is handled through sales of individual company assets, it may be possible to offset any additional tax charge on gains or balancing capital allowances with deductions for large pension contributions.

### **What income will you have in retirement?**

The size of your pension will depend on the amount in your pension fund, your age and the type of pension annuity you want (e.g. flat rate or increasing with inflation etc). It is worth remembering that, for most schemes, it is currently possible to start drawing your pension benefits from age 50, although the minimum qualifying age will rise to 55 from 2010. You can "retire" from one business and take up employment with another, or commence self-employment. It may be attractive to take another, lower-stress job, knowing you can draw your pension simultaneously.

Consider also whether you will want other income streams to supplement your pension income. Depending on the exit strategy you have chosen, you may be able to retain income from the business property, shares in the company, or other investments in the purchasing company. Spreading the risk of your investments is vital. You should take detailed advice from an independent financial advisor.

You can find out more about pensions planning and the new pensions regime that starts in 2006/07 on our website at [www.pensionsreform.co.uk](http://www.pensionsreform.co.uk)

# Disaster area!

When it comes to dealing with the worst, prevention better than cure. This issue's top-ten list looks at the horror stories that could – if you are not careful – happen to you.

- 1 In one acquisition, a manufacturing company chose to ignore the messages of the due diligence. Their unwise purchase had to be liquidated. *Always be ready to walk away.*
- 2 The owner of a printing firm wanted to sell it, but 95% of his sales were to one customer. The business was unsaleable. Then the customer went bust. *Remember what they say about eggs and baskets.*
- 3 A delivery business secured its biggest-ever contract, with a mail-order catalogue. But, lacking the resources, it literally “failed to deliver”, got fired, and the resultant losses wiped out the company. *Never bite off more than you can chew.*
- 4 A French vineyard agreed a price in Euros with their English client. But by the time the supermarket paid for its wine, the Euro had fallen significantly, leaving the seller with negligible profit. *Always hedge in major overseas transactions.*
- 5 A music and software club installed a costly new IT system that would streamline their delivery to customers. It failed to work on schedule, hundreds of orders went astray and membership was decimated. *If it's business-critical, test it and test it again.*
- 6 A small business had an errant director who forged a massive cheque. Only by chance was the cheque stopped. *Have secure cheque-signing procedures.*
- 7 Fire at its London head office damaged an advertiser's central server. Their backup system was inadequately updated, resulting in weeks of lost data. *Are your disaster-recovery plans sufficient?*
- 8 A haulage firm netted a huge contract from their biggest customer. They were overjoyed. They overcharged. They got the sack. *Don't bite the hand that feeds you.*
- 9 Too many companies have signed legal documents without proper scrutiny by a lawyer, or signed off accounts bristling with dubious debits. This is not a place to save time or money. *The signature is only the end of the signing-off process.*
- 10 And a might-have-been: early in October 1984, Greenall Whitley acquired a number of hotels. Days later, the Conservative party were holding their annual conference in one of them, in Brighton. *Always remember to put new insurance in place on acquisitions. Luckily, Greenall Whitley did.*

Do you have a cautionary tale to tell? Log on to PKF's discussion forums at [www.pkf.co.uk/forums](http://www.pkf.co.uk/forums) to share your story, or offer up your questions, comments or insights on any other business-related issues.

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