Welcome to the January 2018 edition of Your Business - our regular round-up of news, views and advice specifically for growing companies, their owners, directors and shareholders.

In this edition, we take a look at the year ahead, explain what the forthcoming IFRS16 Leases standard will mean for your business and clients, and outline a few recent tax rules.

The year ahead: a land of hope…if not always glory

'May you live in interesting times' is an old Chinese proverb and one that feels very appropriate in Britain in 2018.

As head of PKF Littlejohn's advisory team, this is the time of year at which I traditionally dust down my crystal ball and predict what SMEs can expect from the forthcoming year. I don't expect my predictions will make particularly pretty reading but, for what they are worth, here are my thoughts.

Brexit

There is no doubt that almost everything that happens in the corporate world in 2018 will be viewed through the prism of Brexit. Or, to put it another way, businesses are going to have continue to deal with considerable uncertainty and investors will only consider parting with their cash if there are enough strings attached. Being a business owner will not be fun; suppliers will be watching credit terms like hungry hawks; and customers will come up with creative ways to delay payments (and if that means forcing you into an insolvency process, well, that's just one less mouth for them to have to feed, from their point of view).

In tough times, a spike in litigation activity is a given. At least we have some good news on that front – our new Escalate dispute resolution process is already helping to unlock over £10 million in cash for businesses involved in a wide range of disputes. Read our **guide to the commercial dispute resolution process** to find out more.

Fraud also tends to increase; in fact, we have already seen a rise in enquiries to our Fraud and Forensic team from victims who are keen to recover their money.

Interest rates

We have recently seen the first rise in interest rates in over 10 years - and I expect there to be at least one further increase on the agenda for 2018.

Borrowing money has been so cheap for so long that it will be interesting to see how businesses (and consumers) cope with the challenge of having to pay more to access capital. It is no coincidence that the number of corporate insolvencies have (apart from a spike in 2016 relating to the collapse of personal service companies following a change in tax legislation) fallen year-on-year since 2008, when the current era of low interest rates came into existence. It should therefore come as no great surprise if the increase in bank rates is mirrored by a corresponding rise in corporate insolvencies.

Should I give up now?

I can hear you asking the question - and of course you shouldn't! Britain is a land of hope, if not always glory. And one person's recession is another's opportunity.

Take time to look at your business. Are your debtor days acceptable or could credit control be improved? Are you too lenient with customers with whom you have traded for a long time? Are you overly reliant on one customer who can take advantage of its purchasing power to continually squeeze your profit margins? What do you do to prevent late payment becoming a bad debt? Can you outsource any of your functions (then speak to my colleague, **Keith Steele** for advice on ksteele@pkf-littlejohn.com or +44 (0)20 7516 2368)? If you are looking for new premises, could you consider serviced accommodation rather than being tied to an inflexible lease?

Finally, keep an eye on your competitors – they will either be doing something right (which you may be able to replicate) or doing something wrong (in which case you need to get close to their customers).

If you would like to discuss anything mentioned in this article, please contact **Stephen Goderski**, Head of Advisory Services, on +44 (0)20 7516 2224 or sgoderski@pkf-littlejohn.com

One year to go: what does the new IFRS 16 Leases standard mean for you and your clients?

If you're involved with leasing assets and prepare your financial statements under International Accounting Standards, IFRS 16 (the new leasing reporting standard) will affect your financial statements and the preparation you need to undertake in order to implement and maintain ongoing compliance; this does not affect financial statements prepared under UK GAAP (FRS 102).

The good news for lessors is that this new world of lease accounting doesn't hold too many changes, other than some additional disclosures. If you lease assets, however, then you should start preparing now for a transformation that has the potential to affect your business's KPIs, funding covenants and staff incentive schemes. So, what should growing businesses start thinking about over the next few months?

A fundamental change

To date, it has been accepted that there are two types of leases: finance leases and operating leases. All this will change on 1 January 2019 (some of you may have already adopted IFRS16 from this month, if you are also applying the new IFRS 15 revenue recognition standard). From the implementation date, all leases - with the exception of short-term leases (those with less than twelve months duration) and low value assets (typically less than US$5,000 or £4,000) - will go on to the balance sheet as finance leases.

If this feels like tomorrow's problem, it's worth noting that there could be a significant impact on your comparative amounts, despite the transitional and grandfathering provisions. Even if you're not fazed by the task of working through the impact on the past, it's worth getting to grips with the future impact as early as possible so you can start managing stakeholder expectations and potentially renegotiating borrowing terms where there are gearing covenants.

Don't forget that entities that adopt IFRS are required to consider and disclose the impact of yet to be implemented new accounting standards on future financial statements, and that applies to financial statements to 31 December 2017.

So what should you start thinking about over the next few months?

Valuing leases – the challenges

The underlying business and its key cash flows remain the same before and after the implementation of the new financial reporting standard, So the adoption of the new standard should not alter the fundamentals of the business.

One of the drivers behind the new standard is transparency to allow greater comparability between businesses. With all leases going on to the balance sheet as finance leases, a valuation exercise will be needed to work out the value at which to recognise the asset and corresponding lease obligation. The process of accounting for the value of finance leases will not be new in most cases, so what is the big issue?

The challenge may come in many forms:

- Bringing all leases on to the balance sheet and evaluating the carrying value of the lease obligation each year will give rise to greater balance sheet volatility than previously experienced. Depending on a business's KPIs, volatility in net asset value and key ratios, this could affect market perception.
- A company's articles of association or funding terms may include a gearing related financial covenant. Bringing lease obligations on to the balance sheet may trigger a covenant breach.
- Although there shouldn't be a significant impact on profit before tax, there will be an increase in operating profit, finance costs and EBITDA because the rentals currently payable under operating leases are now being sliced up between a finance cost and depreciation. Again, this could have an impact for funding covenants that have an interest cover cap. Similarly, if you have an option or other staff incentive scheme linked to operating profit, the application of the new standard could trigger an earlier than expected achievement of targets.
- The allocation of cash flows within the statement of cash flows alters under the new standard, which may also have a bearing on financial covenants.
- Where you are providing a bundled service, part of the service agreement could be a lease. Such an agreement will need to be looked at closely to establish if it 'conveys the right to control the use of an asset in exchange for consideration'. After carrying out such an analysis, you may find yourself having to unbundle the contract for services into two or more components and account for the leasing and non-leasing components separately.
- Calculating the amount to bring on to the balance sheet requires an understanding of the minimum expected cash flows, how to deal with options to extend, residual value guarantees and identifying the interest rate implicit in the agreement, to name a few considerations. For new leases this may not be too difficult, but it may require more diligence for legacy leases.
- There are additional considerations where your lease payments are variable. Examples include indexed linked leases, leases with a usage linked element or a rent with a component linked to revenues.
- Having captured the legacy leases, you will need to quantify the impact relating to the prior years and identify the most appropriate transitional arrangements.

What are the tax implications?

As part of the IFRS implementation process, HMRC consulted with stakeholders to consider views on how leases should ne taxed under the new Accounting Basis. Finance leases and operating leases are treated differently for tax purposes for both lessees and lessors, and these changes would have significant impacts on the tax base for companies if all significant leases are brought onto the balance sheet. The vast majority of respondents said that the current tax treatment of operating leases be retained, and HMRC is proceeding with that approach.

This will mean that for lessors and lessees who enter into operating leases that are brought onto the balance sheet under IFRS 16, the tax treatment will diverge from the accounting treatment, with rental payments brought into tax when made, and the right to claim Capital Allowances remaining with the lessor. The divergence may complicate the tax calculation position (with potential impacts on the Deferred Tax charge, due to the timing mismatches that will arise), but is generally considered a positive outcome.

Managing the transition

The following suggestions may help ease the transition:

- Start as early as possible and don't underestimate the task.
- Start analysing your known operating leases. Look at the lease length and asset value if less than US$5,000 or £4,000, to strip out those short-term and low value leases. Focus your efforts on the long-term and high value leases.
- Review contracts for services agreements to identify if you have to unbundle – for example, a service agreement that includes fully-maintained equipment available for use or where the back office services have been outsourced, thereby creating a bundled lease and service agreement.
- Evaluate the likely financial impact on the current year and best estimate for the future. With the benefit of this knowledge you may well need to brief your broker and, where relevant, your Nomad if you are listed. Also consider including some explanatory paragraphs in your strategic report to avoid surprises down the line.
- Review your borrowing terms and your articles of association to identify any gearing caps. Where these exist and you anticipate a technical breach on adoption of the new standard, advanced discussions with your lenders might enable you to renegotiate caps or secure a waiver to recognise that the covenant calculation is 'frozen' under the old standard calculation.
- Review any staff incentive schemes and discuss the impact with employee representatives. The equitable and most transparent solution could be to agree on a 'frozen GAAP' solution.
- Make sure that your accounts team is trained on the operation of the new standard and that your accounting systems can capture the information needed for ease of on-going compliance.

If you would like to discuss anything mentioned in this article, please contact **Tim Herbert** on therbert@pkf-littlejohn.com or +44 (0)20 7516 2249.

VAT on the www: new rules for e-commerce sales

With internet sales rapidly increasing year on year, the EU is putting measures into place to simplify VAT for online businesses to combat VAT fraud.

The new rules include extending the existing 'mini one-stop shop' portal so that it applies to the distance selling of goods, and the creation of a new portal for distance sales of goods from third countries with a value below €150. For sales to consumers, VAT will be paid in the member state of the consumer, which is expected to ensure a fairer distribution of tax revenues amongst member states.

The changes also plan to create a level playing field between businesses by making online platforms (such as Amazon and eBay) liable for the collection of VAT on the distance sales facilitated by them. They will be treated as having received and supplied the goods themselves.

At present, goods imported from outside the EU can benefit from a low value exemption, if the goods are valued at less than €22. This exemption entitles traders to import goods VAT free. The new changes have called for the removal of this exemption, to combat abuse of the system.

Moreover, start-ups and SMEs will be able to continue to apply the VAT rules used in their home country, up to a limit of yearly cross-border online sales of €10,000. This new simplification is due to come into effect on 1 January 2019.

The European Council adopted the new rules on 5 December 2017, with the aim of making it easier for online businesses to comply with their VAT obligations, providing cost savings for businesses, and increasing tax revenues for member states. The rules are also expected to allow for improved administrative cooperation between member states. The new 'mini one-stop shop' system will also relieve online traders of the burden of having to register for VAT in each member state in which they operate.

With the exception of the simplification measure for electronic services these measures will come into force from 1 January 2021.

Please contact our **Indirect Tax Team** if you have any queries in relation to the VAT treatment of online sales.

Budget recap: freeze to VAT registration and deregistration thresholds

In the recent Autumn Budget, the Chancellor announced the threshold at which businesses need to register for VAT will be maintained at £85,000 until at least 31 March 2020.

This is the highest threshold in the EU and is favourable for small businesses wishing to price competitively, as well as to those where the administrative burden would exceed the tax savings that being VAT registered can bring.

The deregistration threshold will also remain at £83,000 until 31 March 2020.

Please contact our **Indirect Tax Team** if you have any queries in relation to VAT registration.

In the news: should Carillion have been allowed to fail?

The UK's second biggest construction firm went into liquidation recently, sending shockwaves through the business community and leaving thousands of SMEs out of pocket. Should the government have intervened to save Carillion?

Yes	**No**
Unpalatable though it may be to admit, some firms *are* simply too big to fail. Tens of thousands of jobs are at risk, thousands of SMEs are owed considerable sums of money that they are now unlikely to receive, and dozens of major public sector contracts have been put on hold because of Carillion's collapse. Government intervention could have prevented this either by supporting Carillion through its current cashflow difficulties or by managing the company's closure in a more orderly way.	If the government starts bailing out companies, where does it stop? What message does this send to leadership teams at other large businesses? And why should shareholders be bailed out with the public's money? The fact is that corporate failures are inevitable (and, some may argue, essential) in a successful capitalist economy.

If your SME has been affected by Carillion's demise, you can find out more about your potential next steps **on a website created by the Official Receiver**.

If you are concerned about the impact of Carillion's collapse on your cashflow, and are in need of additional funding, please contact **Alan MacRae** in our Funding Solution team on amacrae@pkf-littlejohn.com or +44 (0)20 7516 2265.

Ask the experts

In each newsletter, our panel of experts answers a reader's question about an issue affecting their growing business. In this edition, Ian Singer, our IT assurance partner, provides guidance on preparing for the forthcoming data protection regulations

Q: How do I prepare for the new General Data Protection Regulations (GDPR) that come into effect in May?

A: Although there are many similarities with the existing Data Protection Act, GDPR introduces a number of additional and more stringent requirements. As a result, it is regarded by many as a game-changer that will transform how SMEs store and process personal data. Preparing for GDPR will be a major task for many SMEs, and you shouldn't underestimate the time and effort that you'll need to invest. But you're not on you own - **our checklist** provides a starting point for your preparations and our team is here to help.

For more information on GDPR, contact **Ian Singer** on isinger@pkf-littlejohn.com or +44 (0)20 7516 2236.

Have a question for our experts? Email **Julia Krol** on jkrol@pkf-littlejohn.com

What do you think? The year ahead

What do you think will provide the greatest opportunity for your business in 2018?

1. The weak pound
2. New technology
3. Stronger economic performance in the EU and US

Click here to take-part in our survey

We hope you've found this issue useful. If people within your business would like to receive future issues, please send their details to Julia Krol (jkrol@pkf-littlejohn.com).

Our specialist team is here to help. If you would like advice on any of the issues discussed in this newsletter, please contact one of our Growing Business specialist partners.

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