

The Technology Business from Spin Out to Exit

a different perspective a broader view

Contents

1. Introduction	1
2. Business Plans	2
3. Funding	5
4. Business Structure	8
5. Directors' Responsibilities and Duties	10
6. The Management Team	11
7. Operational	13
8. Compliance	15
9. Taxation	18
10. Growing the Technology Business	22
11. Exiting the Technology Business – Trade Sale	24
12. Exiting the Technology Business – Flotation	28
13. Acknowledgements	31
14. Contact Us	32

Introduction

As the number of technology start-ups increases, more and more people with a non financial background are finding themselves responsible for the day to day operation of a new business.

Understandably this will be daunting for many individuals who would never have anticipated that they might end up in such a position. Even those with experience of working at a senior management level within business may not have anticipated being in a similar position without having the framework that a larger organisation provides.

Technology based businesses in their earliest stages have key differentiators from other more traditional businesses as follows:

- External investors and continued need for external funding;
- Predicated on some form of intellectual property;
- It may be some time – often years – before revenue is generated; and
- At outset, a relatively short period before planned exit for shareholders, whether through trade sale or flotation

While this guide won't tell you how to run your business and make it successful, it does include details of the key areas that anyone responsible for running a start-up company should be aware of. This includes many of the compliance areas that are important for businesses to get right, as non-compliance with employment law or failing to pay over taxes to HMRC will result in fines and penalties and could ultimately result in the company or its directors committing a criminal offence.

It also provides a useful overview of some of the key issues facing management of a technology business, from writing the first business plan, funding the business at each of its different stages to possible exit routes for investors whilst the guide focuses on financial and strategic issues, thought also needs to be given to IP protection and marketing strategy.

Overall though, the key message is that whilst running a start-up technology business and successfully managing it to become a profitable business can be challenging, it can be extremely rewarding both financially and emotionally to see core technology translate into something commercially viable. This is something that the right professional advisors will understand. While they won't be able to make business decisions for you, it is vitally important that any management team builds a close relationship with trusted advisors who they can turn to, what ever the stage of their business, so that the internal team can concentrate on what they're good at.

Business Plans

The business plan is an important document for any business, as it sets out the business' aims and how it expects to achieve them. For a technology company a business plan is essential from the earliest stages.

- Document the management team's objectives and how they consider they will achieve these;
- Provide a tool for communication with potential third party funders;
- Provide benchmarks against which the company's progress can be measured both internally and externally; and
- Be used as a management tool.

.1. Contents of the Business Plan

There are key components that any technology business seeking to use the business plan as a tool to raise investment should ensure are included within the plan as follows:

- Executive summary;
- Market and commercial opportunity;
- Technology upon which the business is predicated;
- Management team;
- Funding; and
- Financial plan.

These are dealt with in more detail below.

.11. The Executive Summary

The executive summary is the most important section of a business plan as it is the first section that many people will read.

Very often the executive summary is used as a stand alone document to elicit interest from investors. It is, therefore, important to communicate your messages and conclusions in a way which will interest your audience and encourage them to read more.

The key features of a good executive summary are that it is short, precise and simple, allowing a good understanding of the overall business plan without including a lot of unnecessary detail. The easiest way to understand what to include is by considering what might be included in the executive summary of a business plan used as a fundraising document for a technology business.

The key information to include is:

- What the technology is and what **problem** it will be solving;
- The scale of the potential market for the technology;
- The key details of the management team;
- The level of funding that is being sought and how this will be used in the business; and
- The expected exit route for investors.

.12. **Market and commercial opportunity**

This section should include a description of the industry which the business will operate in and a summary of how it is likely to develop. This should illustrate a good knowledge of existing and potential markets and include the highlights of and conclusions drawn from any market research that has been conducted. As well as an overview of the market it should include a consideration of any competitor technologies and how the business' technology distinguishes itself from that of the competition.

.13. **Technology**

The technology the business is developing is fundamental to its business plan, so it is important that the plan summarises all of its key features. As well as the more scientific features which make it innovative, the plan also needs to highlight how the technology will be commercialised to allow the business to extract value.

This will be the key driver behind the level of funding the business requires, as taking the technology from its start-up phase to a stage where it is a fully commercialised product can be very expensive.

It is important to strike the right balance between technological information and the more commercial details. The business plan should concentrate on the commercial upside and should not be an academic treatise. It is sometimes difficult for those with a more academic background to extract themselves from the technical detail of the technology but it is vital that they do so.

.14. **Management**

As important to an investor as the technology, and its commercial application, is the quality of the management team, who, after all, will be responsible for the custody of the finances the investor will be entrusting them with. The key information investors will be interested in is the relevant background, skills and the contribution each member will make to the business. It is important this is relevant and does not just list all the "badges" the team members have, but the background information for each member of the management team should demonstrate that they possess the experience and skills which are required for the current role. Of particular relevance will be whether the individual members of the team have ever taken a similar business through spin out or start up to profitable exit. See section 6 for further details.

.15. **Funding**

This section should include the level of funding required by the business and how this will be used. Key information to include in this section is:

- Whether this will be taken in tranches;
- Current and future funding requirements;
- Milestones against which the company's financial performance can be measured;
- How the required funds will be used and where this funding will get the business to.

.16. **The Financial Plan**

The financial plan should be developed after market analysis has been completed and clear objectives have been set. The critical financial information to include in the business plan is any historical financial data and financial forecasts. The historical financial data to include (if there is any) would be the company's key financial statements, including the profit & loss accounts, balance sheets, and cash flow statements for the last three years. Forecasts should cover the next 3-5 years and include forecast versions of the key financial statements, together with a summary of the key assumptions which have been made in building these forecasts.



Funding

A key issue for any technology business is how to meet an identified funding requirement so that the business can reach the next stage of its product development.

The identification of a funding requirement, ideally over a year before it is needed, is one of the key outputs of a business plan. It is important to regularly update financial forecasts to allow the management team time to raise funds before a lack of funding becomes critical to the business.

Once a funding requirement has been identified there are several different types of funding, the suitability of which will depend where in its lifecycle the business is. It is important in deciding to approach only one individual or entity for funding to have carried out your research properly so you ensure you only approach those whose investment criteria you fit.

.1. Grants

Grant funding is generally provided by the UK and EU Governments, Regional Development Agencies and some interest groups such as research councils or charitable institutions such as, for example, Wellcome Trust or Cancer Research, who offer grant funding for specific pieces of research. This is the cheapest form of finance and an important part of the funding package for start-up companies.

The main advantage of grants is that they provide cheap finance which may take the form of a subsidised or zero-interest loan, or even an outright cash grant. In addition, support schemes can provide expert advice, information or subsidised consultancy.

However, there are drawbacks, including strong competition for grant schemes, the requirement to meet the grant's offer criteria and complete the application procedure, which can be long and complex, and the requirement to match any grant funding as grants do not usually cover 100% of a project's expected costs. It is also important to consider the interaction with Research & Development tax credits, (see section 9)

.2. Equity

Equity essentially comprises funds invested in a company in return for shares in that business.

Companies at every stage of their development may raise funds from the issue of equity shares, but the nature of the investor will change as the company enters different stages of its development.

3.21. Friends and Family

At the very earliest stages friends, family and acquaintances of the original management team are often a key source of funding and are less likely to require a direct involvement in the business than other investors may do.

3.22. Business angels

These are high net worth individuals looking for investment opportunities, who will also often act as a source of expertise for the management team. Many of them will have

significant experience in the technology area – perhaps having successfully exited from another business. The typical investment size for an individual business angel is £25,000 to £250,000 but some can go as high as £2m for the right opportunity. As the average individual investment is fairly small angels often like to invest in syndicates, spreading the risk across all investors with one angel taking a lead role. They will usually look to exit the company within 3-5 years.

The advantage of using business angels is that they can offer more than money by providing expertise and experience.

However, the disadvantages are that they can be difficult to find and managing the various interests of a large group of angels can be challenging.

It is generally best to make approaches to angels through an intermediary or network rather than targeting them directly.

3.23. Venture Capital

These are investment funds seeking high rates of return on investments which are typically £2 million. Some funds are targeted at making investments below this value depending upon the sector and region. These funds are looking for companies with a high earning potential that are able to offer a defined exit plan and timetable, usually in the form of a sale or flotation. Increasingly, such funds will not be interested in investing unless the company is already generating revenue or close to this stage.

Venture Capitalists will want to get their money and profits out as fast as possible. It should be borne in mind that in making an investment they will typically want to have more control over the company than an angel will. This usually takes the form of a director on the board.

Only 1% of business plans received by venture capitalists are successful in securing investment.

.3. Debt financing

Debt finance will usually only be relevant in circumstances where a company is revenue and profit generating. Overdrafts and bank loans are common sources of debt finance. Before lending, a bank will want to know that the company is a good risk. Typically, the company will need to present a credible business plan, provide evidence that the management team are competent and have a successful track record in business.

Whatever the type of borrowing used the company will probably have to pay arrangement fees as well as interest. Terms and rates depend upon the bank's risk assessment of the company. Repayments can be very flexible to meet specific needs.

A bank lender will also require some form of security, either from the company, (in the form of a charge over the company's assets), or from the directors (in the form of personal guarantees), or both. A personal guarantee will require the directors to guarantee the company's ability to repay the debt by securing the loan against one of their assets, (usually their family home), unless they have other substantial assets.

.4. Business Relationship Funding

This is another source of funds that can be overlooked. It may be possible to introduce potential alliances to add value to both parties. It may produce an ultimate exit route in the medium to long term.

- **Joint Ventures:** Requires a legal agreement embodying the deal and another company;
- **Partnerships:** Two companies collaborate with possible funding;
- **Joint working relationships:** These are an informal partnership which may be more project specific where the parties can share resources;
- **Agencies:** These can be geographical or product specific and generally incorporate a payment for the right to the agency;
- **Alliances:** These do not require a separate company and can be embodied by a legal agreement to work together;
- **Trade investors:** Otherwise known as Corporate Partnering. This can be a good way to involve a much larger company in the business with a view to a possible trade sale to them further down the line;
- **Franchises:** This can allow the business to grow with minimal further direct investment;
- **Licensing:** This involves licensing intellectual property; a product or service to enable others to sell it or utilise it in some way. This can be a valuable source of revenue – and hence funding – for technology-based businesses in their earliest days.

Business Structure

.1. Choice of Business Structure

The immediate decision facing all business owners when setting up a new venture is whether to operate the business structure through a limited company, partnership or as a sole trader. There are a number of commercial and tax considerations to take into account when making this decision.

An unincorporated business has fewer statutory requirements to comply with and has the advantage of not needing to keep information in the public domain (with the exception of Limited Liability Partnerships or LLPs).

A company is a preferable structure for a technology-based business.

- The technology sector has always carried a high commercial risk. As such, the formation of a limited company provides the owner(s) with some protection under the limitation of liability that comes with a corporate structure. Each shareholder's liability is restricted to the capital they have introduced, although this limited liability is likely to be diminished in many cases where any personal guarantees have to be given to banks and other funders;
- A corporate structure makes it much easier for investors to take a stake in the business at the appropriate stage of product development. Indeed, investors are unlikely to invest in anything other than a limited company, as there is no easy means for them to get the return on their investment in any other structure;
- It is far easier to incentivise and reward staff in a corporate structure, particularly by having the ability to use share options and incentives as an alternative to cash bonuses;
- Many tax breaks relevant to the technology industry are only available to companies – principally these include Research & Development Tax Relief (see section 9) and payable credits for investment in green technology; and
- A limited company benefits from lower tax rates than a sole trade or partnership business – but the difference is not enough for this to outweigh the commercial considerations above.

There are some advantages in keeping a non-corporate structure, however, including the following:

- If profits are low, such that Income Tax and National Insurance are payable only at lower personal rates, the tax burden can be lower;
- If losses are made, these can be immediately used against the personal income of the business owner(s) to reduce tax;
- A business could be operated as an unincorporated entity in its early stages to make use of the losses as above, then transferring to a limited company at a later stage, before seeking further investment or implementing any share incentive schemes. However, this strategy could be risky from a tax perspective and advice should be sought before following this route.

Typically a business in the technology sector will be either a private or a public company. Private companies are denoted by having the suffix “Limited” appended to their name, whereas public companies have “Public Limited Company or Plc” appended to theirs.

The key difference between them is that a Plc is subject to far greater regulation than a limited company – for example, it has to have a minimum of £50,000 of share capital, compared with a limited company only needing £1. Directors may choose to make their company into a Plc for prestige and marketing, including, for example, the ability to gain some public sector contracts. If they are intending to float that company, having Plc status is prerequisite.



Directors' Responsibilities and Duties

Every limited company is requested to have a minimum of one director, who is responsible for the running of that company, while a Plc must have a minimum of two. Being the director of a company is more than just a job title, it involves serious responsibilities and duties that if breached can, in some cases, have severe consequences including potential criminal liability. Additionally the protection afforded by limited liability can be removed if it is concluded that a director has acted improperly.

The duties and responsibilities of a director are set out primarily in the Companies Act 2006, but, there is a whole range of legislations from Health & Safety to Environmental that include responsibilities for directors.

.1. **Directors' Duties**

In simple terms, the company and its interests come first. A director's duty is primarily to the company. Even sole director/shareholder companies must consider the implications of their actions by not putting their own interests above those of the company.

The following summary was published by the Government in June 2007 to aid directors in fulfilling their duties. This provided general guidance on the expected conduct of directors:

- Act in the company's best interests, taking everything you think relevant into account;
- Obey the company's constitution and decisions taken under it;
- Be honest and remember that the company's property belongs to it and not to you or its shareholders;
- Be diligent, careful and well informed about the company's affairs. If you have any special skills or experience, use them;
- Make sure the company keeps records of your decisions;
- Remember that you remain responsible for the work you give others;
- Avoid situations where your interests conflict with those of the company. When in doubt disclose potential conflicts quickly;
- Seek external advice where necessary, particularly if the company is in financial or legal difficulty;

Applying the guidance summarised above will help directors fulfil their duties and responsibilities.

The Management Team

The key to a successful business is undoubtedly having a quality management team. Potential investors will (rightly) be as interested in the management team's experience, relevance and capability as they are in the core product or service the company might provide.

In recent years the majority of business failures have been attributed to failures of management rather than being as a result of adverse external influences, so getting the right management team in place is vital.

There are several key factors which need to be considered when a management team is being formed;

.1. **Background**

What is the background of each member of the team? Where have they gained their experience and is it relevant to the current business? In many circumstances it is not necessarily specific industry experience that is relevant but more the experience of working in a business of this size and type i.e. experience of managing and developing a technology start-up.

It is also important to consider the standing of each of the management team amongst their peer group outside the company. How they are viewed externally is particularly important when the company is seeking funding.

.2. **Skills**

Does the team as a whole contain all the core skills that are required to operate this particular business? Core skills will normally mean sales; marketing; finance and admin; production/operations.

.3. **Roles**

Is the team balanced in terms of the team roles that each of the individuals play within it? It's no use everyone being full of great ideas as to how to drive the business forward if there is no one to deliver on those ideas.

A balanced management team is essential to sustained success.

.4. **Working Relationships**

How do the members of the team relate to each other? If there is obvious antagonism this will impact the smooth running of the business.

It must, however, be recognised that in its earliest years a technology company may well not be in a financial position to recruit an internal management team that can cover all the aspects mentioned above. In these circumstances the company is more reliant on the other half of the team – the external advisers.

A typical external team might include:

- Scientific advisory board;
- Patent attorney;
- Lawyers;
- Accountants;
- Marketing/PR consultants;
- HR support; and
- Bankers.



Operational

Operating a new business as a member of a management team means that certain procedures need to be put in place to enable the business to meet its statutory responsibilities. These largely fall into four types:

.1. **Employment and Human Resources**

As employment law grows more complex with increased risk of employment claims it is important to ensure the business' HR system takes account of all the key regulatory requirements. Having HR systems in place is not intended to stifle creativity and entrepreneurial style, but to ensure everyone is treated fairly and knows what they are entitled to. Putting the correct systems in place from the start will save valuable management time in the long run.

The requirement to comply with employment law begins with your first employee. Therefore, as a minimum you should have in place legally compliant contracts of employment for your employees and Directors. These should set out the main terms and conditions of employment, and need to comply with various statutory entitlements.

As a minimum, employers are expected to have disciplinary and grievance procedures in place, although it is highly recommended that policies and procedures are in place for all employee/employer statutory regulations.

Other important legal and practical considerations are that employee records will need to be kept for all employees. These should include keeping safe, secure, confidential personnel files which will include details of an employee's proof of right to work in the UK (e.g. copy passport, etc) and payroll information (e.g. tax code, NI, bank details etc).

Non-compliance with regulations could mean a fine of up to £10,000 or two years in prison. You will also need to obtain advice on other issues like statutory sick pay and maternity pay, employment tax, etc. As you grow and employ 5 or more staff, you have further statutory requirements like providing a Stakeholder pension scheme, as a minimum.

New businesses set up since 22 June 2010 will qualify for an National Insurance Contributions ("NICs") "holiday" for the first 12 months of the trade. This means that, for the first 10 employees taken on in that period, up to £5,000 of employer's Class 1 National Insurance will be waived for each employee. This is therefore worth up to £50,000 for a new business.

The scheme, at the time of going to press, is expected to start on 6 September 2010 and will last for three years. However, businesses which start to trade between 22 June 2010 and commencement of the scheme will still qualify for the NIC holiday for the 12 months after the scheme commencement date, although all employer's NIC up to this date will still need to be paid as normal.

.2. **Insurance**

Make sure you have all the relevant insurance policies in place. Legally you need to have Employers Liability Insurance and Public Liability Insurance. Depending on the nature of your business, it may also be advisable to have Professional Indemnity Insurance and Key Man Insurance.

.3. **Health and Safety**

Employers and employees have a duty to act responsibly under the Health and Safety regulations and this extends to welfare issues like preventing stress in the work place.

You will need a Health & Safety Policy, and will be required to undertake various risk and Control of Substances, Hazardous to Health Regulations (COSHH) assessments depending on the nature of your business. You will need to consider aspects like first aid, fire precautions and ensure these are communicated to employees.

There is also legislation relating to Corporate Manslaughter, which you will need to be aware of. Non-adherence can mean hefty fines, prohibition notices, prison sentences and/or breach of employment contract claims for breach of duty of care.

.4. **Books and Records**

All UK limited liability companies are required to keep records of their financial transactions. These records must be sufficiently detailed to accurately assess the financial position of the company at any given point and to enable it to prepare a profit and loss account and a balance sheet.

When raising finance any potential investor will expect the company's accounting records to be complete and accurate.

The records should contain details of all income and expenditure and allow the company's assets and liabilities to be separately identified.

Records can be maintained in different formats, although which is the most appropriate will depend on the size or complexity of the company. Start-up businesses with few transactions may be able to record them on a simple spreadsheet whereas a more comprehensive accounts software package will be more appropriate for larger businesses.

Record keeping should be systematic.

External funders will typically require that a company produces monthly management accounts so they can monitor actual performance against forecast.

In addition to maintaining accurate financial information it is good practice to perform reconciliations of key control accounts such as the bank, VAT, net wages and PAYE to identify any errors or omissions and ensure that the company's reported cash flow position is accurate. Adhering to these basic principles will enhance the reliability and accuracy of standard system reports and other management information. Ready access to sound financial information reduces potential time costs in preparing accounts and other financial documents, such as VAT returns. This minimises the time devoted to answering queries and results in more effective decision making by management.

The Companies Act 2006 requires books and records to be retained for three years. However, HM Revenue & Customs can open an investigation up to six years after the period in question and it is therefore advisable to retain original records for at least seven years.

Compliance

Companies incorporated in the UK have to comply with various statutory requirements, with increasing penalties for non-compliance.

The following are the key issues to be aware of:

.1. Accounting Reference Date

Each company needs to set an accounting reference date which it will prepare its accounts to each year. When the company is incorporated the year end will, by default, be set as one year from the end of the month of incorporation. For example, a company incorporated on 16 August 2009 will prepare its first set of accounts for the period ending on 31 August 2010.

- You can change an accounting reference date by shortening an accounting reference period as often as you like and by as many months as you like. However, there are restrictions on extending accounting reference periods: An accounting period cannot exceed 18 months in length unless the company is in administration;
- A company cannot extend its accounting reference date more than once in five years unless:
 - The company is in administration
 - The Secretary of State has approved the change
 - The company is aligning its accounting reference date with that of a subsidiary or parent under UK or European Economic Area law
- It is not possible to change an accounting date for a period for which accounts are overdue.

.2. Preparing and Filing Accounts

All companies must prepare accounts that report on their performance and activities during the financial year. Under Companies Act 2006, private companies must file their accounts with Companies House within 9 months of their accounting period end date, while Plc's must file their accounts within 6 months.

Small companies can choose to follow special reporting requirements and disclose less information in their accounts.

To qualify as a small company at least two of the following conditions must be met:

- Annual turnover or revenue must not be more than £6.5 million;
- The gross asset total must not be more than £3.26 million;
- The average number of employees in a year must not be more than 50.

Generally a company qualifies as small in its first accounting period if it fulfils the conditions in that year. In subsequent periods the company must fulfil the conditions in that period and the period before.

Public companies, certain financial services companies and members of ineligible groups cannot qualify as small companies.

.3. Audit Requirements

Unless exempt, companies are required to have their accounts audited. An audit is essentially a review of a company's accounts to report on whether they represent a true and fair view of the company's affairs. Certain small companies may claim exemption from audit.

To qualify for audit exemption, a company must:

- qualify as small (see above); and
- have a turnover of not more than £6.5 million; and
- have gross assets of not more than £3.26 million.

A company that is part of a group is also ineligible for audit exemption unless the whole group meets the following criteria:

- Group qualifies as a small group; and
- Group turnover not more than £6.5 million net (or £7.8 million gross); and
- The combined group assets not more than £3.26 million net (or £3.9 million gross).

Although an audit may not be required, there may be circumstances where a company would nonetheless choose to have an audit. Third party investors will often stipulate as a condition of their funding that an audit is carried out. This may be to provide additional comfort for suppliers or banks, for example, as an audited set of accounts carry the weight of having been independently verified. If 10% of shareholders request it then an audit will also be required.

As noted in section 9 companies are required to account to HMRC for certain taxes. The main administrative requirements for each tax are summarised below:

.4. Corporation Tax Returns

Small companies are required to pay their Corporation Tax (where due) within 9 months and 1 day of the year end. The tax return (CT600) has to be filed within 12 months.

Any difference between the tax liability on the final CT600 and the amount paid within 9 months will attract an interest charge, depending whether the estimated liability was higher or lower than the final one.

Companies which qualify as large have to pay their tax in four instalments. Your accountant will be able to advise you when corporation tax payments are due.

Since 1 April 2011 it has become mandatory to file both accounts and Corporation Tax returns electronically for periods ending after 31 March 2010, so you should make sure your adviser has the facility to do this in the required format.

.5. VAT

VAT returns will generally be submitted quarterly, and must be submitted within one month of the end of each quarter, unless you pay electronically; in which case you may get up to an extra seven days to file your return and pay.

Companies can elect to account for VAT monthly; this would be of most benefit when the company is regularly in a position where it receives a refund from HMRC (input tax exceeds output tax).

There are financial penalties for late returns which increase depending on the number of successive defaults.

.6. Payroll Compliance and Benefits Reporting

Companies with employees (including directors) are required to file numerous forms to report to HMRC and ensure the correct deductions are made from employees pay. The most common of these are summarised below:

- Form P35 – submitted to HMRC summarising pay and deductions for all employees and directors for the tax year. This must be submitted by 19 May.
- Form P45 – issued to a leaving employee or HMRC (for a new employee) detailing gross pay and tax deducted for the tax year to date.
- Form P46 for a new employee starting, unless they have a P45 from a previous employer; in this case there is a section of the P45 which needs completing.

Monthly deductions must be paid over to HMRC by the 19th of each month. (or 22nd if paid electronically). There are potential penalties for late payments of deductions.

There are also financial penalties for late submission of forms P35 which are severe and increase each month until the form is submitted.

All employers are required to complete and file the above forms online.

.7. Annual Returns

Every company must provide Companies House with an annual return. This provides information about the company at its “legal return date”. A company has 28 days from its legal return date to deliver its annual return to Companies House.

.8. Other Company Secretarial Matters

There are other matters which need to be reported to Companies House as they occur, these include:

- Appointments or resignations of directors or company secretary;
- Issues or allotments of shares in the company;
- Company purchase of own shares;
- Reductions in share capital.

When a company pays dividends to its shareholders it is required to prepare dividend vouchers and board minutes declaring the dividend. It is also essential to ensure that the company has made sufficient post-tax profits to be able to pay the dividend. Any dividends paid without sufficient profit reserves in the company are technically void and this has various statutory and taxation consequences which are to be avoided.

Taxation

Companies incorporated in the UK are subject to several different kinds of taxes. The main types are summarised below, together with some tax efficient schemes which start-up technology companies are well placed to take advantage of.

.1. Corporation Tax

Companies in the UK must register for corporation tax which is payable on their taxable profits. Taxable profits are a company's accounting profits adjusted to reflect the tax treatment of certain items.

Corporation tax is charged at 20% on taxable profits up to £300,000, 26% on taxable profits over £1,500,000 and at an effective marginal rate of 27.5% on profits between these two limits. The main rate will also drop by a further 1% each year until 1 April 2014 when it is due to remain at 23%.

.2. Value Added Tax

Value added tax ("VAT") is a sales tax which is charged on the sales (outputs) and purchases (inputs) of a company.

Companies trading above the turnover limit set by HMRC are required to register for VAT, meaning they must add VAT to all their invoices and remit this to HM Revenue & Customs. It also allows them to recover VAT on most of their costs, making VAT cash neutral for many businesses. In the following circumstances a company must register for VAT:

- Where the turnover limit is exceeded in any 12 month period. The limit is currently £73,000 and generally increases each year. This is a rolling test, so every month a company needs to total its sales for the previous 12 calendar months to see if registration is required;
- Where it is expected that the turnover limit will be exceeded in the next 30 days.

A company may elect to register for VAT when its turnover is below the current limit of £73,000; if it is regularly in a repayment position (i.e. HMRC owes it money). This is likely to be useful when the company is in a start-up position and needs to recover as many costs as possible. In order to be able to register in such circumstances the company must be able to demonstrate that it is being set up with the intention of running a business that will be generating profits.

Since 1 April 2010 many VAT-registered businesses have had to switch from paper to online VAT Returns. From that date, if your turnover is on or over £100,000, or if you are newly VAT-registered, you will have to submit your return online and pay VAT electronically. The VAT rate is currently 20%.

.3. PAYE

PAYE (Pay As You Earn) is the system that HM Revenue & Customs (HMRC) uses to collect Income Tax and National Insurance Contributions (NICs) from employees' pay as they earn it.

Companies with employees (including directors) are required to deduct Income Tax and National Insurance contributions from their pay and submit this to HMRC each month.

Details of the returns an employer is required to submit as part of the PAYE system are considered in section 8.

.4. **International Tax**

As technology companies grow they will increasingly operate in the global markets and International Tax may become a consideration. As this is such a complex area it is best to take advice as soon as you think that you may be trading internationally.

.5. **Tax Incentives**

9.51. **The Enterprise Investment Scheme (EIS)**

The Enterprise Investment Scheme is designed to help small higher-risk trading companies, such as those operating in the technology start-up market, raise finance.

A company hoping to attract investment under the EIS scheme must meet the following criteria:

- The company must not be listed on a regulated market or stock exchange;
- The company must not be controlled by another company;
- The company's total assets (before deducting liabilities) must be £7 million or less before the share issue, and £8 million or less after it is complete; and
- The company must have less than 50 employees.

It is expected that from April 2012 the limit on gross assets will increase to £15 million and the limit on the number of employees to 250.

The scheme offers a range of tax reliefs to investors who purchase new ordinary shares in those companies. These reliefs are:

- Income tax relief – a deduction of income tax due of up to 30% of the amount invested to a maximum of £500,000 per annum, (expected to be £1 million per annum from April 2012).
- Capital Gains Tax – gains on the disposal of the shares held under an EIS scheme are exempt from capital gains tax if the shares are held for 3 years. If they are held for less than 3 years any gain can be deferred if an equivalent investment is made between 1 year before the disposal and three years after the disposal.

These reliefs are only available to investors who hold less than 30% of the shares or voting rights in a company, and are not an existing partner, director or employee of the company.

All of the money invested should be used by the company within 2 years of the share issue. The scheme is well suited to a business that requires funding to invest in the short term.

There are a number of restrictions on the type of trade the company can operate to qualify for the scheme, but company's operating in the technology industry will usually qualify. Advice should be sought from a qualified advisor when planning investment under the EIS scheme.

In addition to EIS, additional tax incentives apply to Venture Capital Trusts (investments by VCs). Your tax advisor will be able to provide you with details of these schemes and advise whether they will be suitable for your business.

9.52. Enterprise Management Incentives Share Option Scheme (EMI)

Companies often use shares and share options to retain and motivate key employees, ensuring that the aims and values of the key employees will be aligned with those of the business.

An Enterprise Management Incentives share option arrangement is a flexible scheme which companies can use to extend share ownership on tax-favourable terms, subject to meeting company and employee qualifying criteria.

Share options can be linked to corporate objectives and shareholder requirements. For example:

- Subject to an overall employee limit of £120,000 and company limit of £3,000,000 (as measured by the market value of the shares under option at the date of grant) EMI options can be granted on a discretionary basis to any number of 'qualifying employees'. Furthermore, the company can set any performance and exercise criteria and determine the exercise period that it considers appropriate.
- There is no income tax or NIC liability for the employee when the option is granted. Provided that the exercise price is at least equal to the market value of the shares when the option is granted.
- There is no income tax or NIC liability for the employee when the option is exercised.
- Capital Gains Tax ("CGT") is charged at either 18% or 28% on any capital gain made on the sale of the shares acquired via the EMI Option (depending on whether the shareholder is a higher rate tax payer) unless the option holder also qualifies for Entrepreneurs Relief, in which event some or all of the gain may qualify for a 10% tax rate.

9.53. Research & Development Tax Credits

R&D tax credits are a company tax relief that can either reduce a company's corporate tax liability or, for some small or medium sized companies ("SMEs"), provide a sizeable cash sum. As such they can represent an alternative, and often vital, source of funding.

The system works by giving an extra tax deduction against taxable profits on qualifying R&D expenditure of up to 75%. Subject to EU approval, this is set to increase to 100% from April 2011 and to 125% from April 2012. For SMEs, where the extra deduction creates or increases a loss the SME may be able to surrender the loss and receive a cash repayment instead. Alternatively these losses can be carried forward to future years and used against taxable profits when the commercial exploitation of the technology commences and the business starts to generate profits.

To be able to qualify the company needs to be undertaking a qualifying activity and incur qualifying costs of at least £10,000.

A qualifying activity is defined by UK Department for Business, Innovation and Skills ("BIS") guidelines, but despite the name implying that the regime is only likely to apply to leading edge "blue sky" research companies most claims surround activities that use

science or technology to duplicate the effect of an existing process, material, device, product or service in a new or appreciably improved way, i.e. not blue sky research.

HMRC are eager for companies to claim and have set up specialist R&D units to handle claims to ensure that claims are not denied by inexperienced Inspectors.

Qualifying costs include:

- Employment costs – salary, employers NICs and pension contributions;
- Consumables – heat, light, power, chemicals, prototypes etc;
- Software;
- Sub-contractor costs;
- Costs relating to qualifying indirect activities, for example, admin, functions and training.

In short, if a company is being 'innovative' with the aim of exploiting the results of that innovation commercially then the activities may qualify.

This is a valuable source of funding and companies operating in the technology industry, including those in a start-up position who may not have taxable profits to relieve, should consider whether they are able to make a claim.

Growing the Technology Business

Technology businesses tend to develop extremely rapidly. This speed of development means they have to address a wide range of business issues in a relatively short space of time.

Coping with this rapid growth is key to the success of any technology business, and the main tool to use to achieve this is the company's business plan, which should be used as a tool for the management of the business as useful for the raising of finance.

Many of the key issues a technology business will face will be driven by the core technology and how this is commercialised. For example, when a technology business is at its earliest stages one of the most fundamental issues to address is how the company is intending to extract value from the underlying technology. Alternatives may be:

- Develop the technology to a certain point and then license it out to a range of users. Following this route is relatively cheap and leaves others to bear the risk. However, the company would also reduce its opportunities for profit and will not be in control of the ultimate revenue generation;
- A number of technology businesses (particularly those in biotech) will develop the technology to a defined level and then sell the business. In the case of pharmaceutical development this will often be to Phase I or II clinical trials;
- The company could seek to retain total control over the technology and the product and take it right through to manufacture and marketing. This route can be expensive and risky, but ultimately, if successful, far more profitable than the straightforward licensing model. In this case the company may opt to float in order to raise the extra funding that will be needed to take the technology to its later stage, which will place different demands on the management team than the licensing model.

The two key challenges a technology business will face are:

- Planning the availability of sufficient funding to continue the development of the technology; and
- The ability of the management team to deliver what the business needs at each stage of its growth.

It is rarely the case that the entrepreneurs or academics who founded the company will be the right people to lead it in the long term. This is because the fundamental focus of the business shifts away from the perfection of the R&D towards the marketing and sale of product or as the company seeks to float.

This is why it is important that the management team plan and manage the growth of the company. Not having a plan or strategy may not necessarily mean that the business and its stakeholders will not achieve their objectives, but what is certain is that with a properly defined strategy they will significantly improve their chances of being successful.

A number of technology businesses will also have a strategy to grow externally. For some this will be through international expansion. It may be important to be present in a particular location to:

- Have access to grant funding;
- Have access to investors and markets;
- Have access to particular research teams / skill sets; and
- Run trials.

Whatever the reason, serious thought needs to go into how that presence is to be affected – it is certainly not as simple as setting up a company in the location of choice. Consideration will include:

- How that entity is to be funded;
- The relationship with the original company;
- Who is going to run the new entity;
- Whether there will be employees; and
- Tax considerations

Some companies will have, as part of their strategy, a policy of acquisition of other businesses in similar or complementary areas of trade. The acquisitions may be opportunistic or the result of searching.

Irrespective of the way in which the acquisition originates, the process of acquisition is likely to be broadly similar:

- An offer will be made;
- Heads of Terms will be agreed;
- Due Diligence will be entered into to ensure that the purchaser knows what it is really acquiring. The focus on the due diligence process is very much dependant on what the purchaser perceives to be the real value in the business and the nature of the entity being acquired; and
- Contracts will be finalised.

This is dealt with in more detail in section 11.

Post-acquisition there will be other challenges – working out how the merged entity will operate; proper integration of employees; ensuring that common systems are adapted.

Exiting the Technology Business – Trade Sale

The majority of successful technology businesses will be looking to achieve an exit for the investors in the short to medium term. This will typically be by way of either a trade sale or flotation.

.1. **Planning to Exit the Business**

It is common that in technology businesses the potential trade purchaser will have been identified almost at inception. If this isn't the case the management team should start to plan for the sale of the business at least a year before the anticipated exit date. The planning stage is crucial as if it is executed properly it will have a significant impact on the way any proposed buyer views the business.

For example, if a business is not properly structured, does not produce regular and reliable management information and is unable to produce signed copies of key documents, any potential purchaser is unlikely to be reassured that the business has been well managed. This will increase the level of perceived risk attached to the company and will reduce the price any purchaser is willing to pay.

Some of the key areas to address during the planning stage are considered below:

11.11. The People Running the Business Add Value for a Buyer

Ensure the management team is structured so that the business will be able to operate effectively post sale. Having a strong second tier of management in place will make the business more attractive to any potential buyer.

11.12. Being Organised Promotes Credibility

Ensure that the company's internal documents (especially those relating to intellectual property) are complete, up to date and easily available so that they can be provided to third parties during the sale process. This will need to include board minutes for all major decisions as well as contracts with key management, customers, suppliers and employees etc. Presenting the company as well managed and organised will help with the buyer's perception of the company's value.

11.13. The Value of Information

Any potential buyer will want to understand how a business has been performing and what its respective assets and liabilities are. Having an appropriate management information system in place to produce this information will show that your business places value on good financial management, reducing the level of perceived risk.

Part of the process of ensuring that good, reliable information is produced is to review the systems which operate over the company's key business cycles, such as debtors, creditors and stock control.

.2. **Finding and Approaching Prospective Buyers**

Having made a decision to sell the business the management team will need to find prospective buyers. The main ways to find a buyer are networking through your own business contacts and by using the networking skills and contacts of corporate finance professionals.

Having identified prospective buyers, an initial approach will be made which will generally take the form of a one or two-page leaflet clearly and concisely setting out the acquisition opportunity. It is often useful to use someone to act as an intermediary in this process.]

.3. The Information Memorandum

A key tool in marketing the business is the information memorandum. This document will be prepared by the management team and their corporate finance advisors to attract the attention of potential buyers. Commercially sensitive information should not be included in the information memorandum as some of the companies approached as potential buyers may be direct competitors of the business.

The key to producing a successful information memorandum is to present the business in the best possible light. First impressions are very important and the business needs to be presented in such a way that prospective buyers will appreciate its value and be interested in entering a more detailed sale process.

An information memorandum is a substantial document which should emphasise those areas that are most likely to be of interest to any prospective buyer, while highlighting those points that may increase the value of the business. A typical document might include:

- Which sector your business operates in and how long you have been trading;
- Key financial figures such as profit, cash flow, value of assets and total debts;
- Comparative financial figures for previous years and how they have changed;
- Number of employees and location of premises;
- Any special features of your business; and
- Opportunities for growth or profit improvement.

The actual process of preparing the information memorandum is extremely valuable. It brings a spotlight to bear on all aspects of the business being sold, illustrating strengths in the best possible light and providing an opportunity to identify and correct weaknesses before they are revealed by the buyer's due diligence.

.4. Form of Consideration

There are three main types of consideration, cash, shares and loan notes, and the consideration may well comprise a combination of the three. There might also be an element of deferred consideration.

- **Cash** - The advantage of cash is that it is known exactly how much will be received, and that it can be a clean separation from the business as there are often no remaining ties.
- **Share capital** - Share capital is often used to tie in the existing business owners where it is anticipated their involvement will be required after the business is sold. This is particularly the case where the business is unquoted and therefore a ready market for the shares does not exist.
- **Loan notes** – Loan notes are instruments which are usually either redeemed for cash or converted to shares at some time in the future (the redemption date). Interest is usually paid on the value of the loan notes although the return on loan notes will depend upon the precise terms.

It is usual for an element of consideration to be deferred until some time after the deal. The amount may be dependent on the future performance of the business (an “earn-out”) and is, therefore, not known for certain at the date the contract is signed. The purchaser may offer the former owner of the business a consultancy contract for the earn-out period so their experience is still available for any new management.

.5. Heads of Terms

Initially several bidders may be negotiating with the company, but at some stage a preferred bidder will need to be selected. Whilst competition may drive the price up, purchasers are unlikely to be prepared to incur the costs of a detailed due diligence exercise unless they know that their offer has been accepted, subject to contract.

At this point, it is usual to agree “heads of terms”. These are an agreement in principle of the key terms of a possible sale of the business, and form the starting point for detailed contractual negotiations.

The following matters are normally covered in heads of terms:

- A description of what is being sold and any pre-sale conditions;
- Details of the proposed consideration (amount, what form will it take, will any of it be deferred, is there an earn-out element);
- Agreement of the scope of any due diligence;
- Confirmation that any agreement is subject to warranties, indemnities and details of any restrictive covenants; and
- A detailed timetable to completion.

These elements of the heads of terms are usually described as being ‘subject to contract’. Other conditions will be legally binding such as confidentiality agreements (if not already agreed), any exclusivity period and who will bear the costs of the negotiation.

.6. Due Diligence and Contract Negotiations

Before prospective purchasers commit to buying the business, they are going to try and find out as much as they can about it in a process called ‘due diligence’. The scope of due diligence will be agreed between the prospective purchaser and their advisors.

Where the due diligence process highlights any possible problems, these will usually be resolved by reflecting them as warranties or indemnities in the final sale and purchase agreement.

11.61. Warranties

Warranties are used as a way ensuring that the sellers of a business confirm the full details of a certain element of the business, or risk being in breach of contract. If it is found that the sellers did not disclose their full knowledge and the purchaser suffers financial loss as a result it is likely they will be the subject of a claim for breach of contract. The amount of damages payable is determined by the purchaser’s loss.

11.62. Indemnities

Indemnities are promises that the seller will make payments to the purchaser in certain circumstances. Common tax indemnities include promises to pay any tax liabilities which

arise in the acquired company because of the previous relationship with the vendor, or underpaid tax, interest or penalties relating to returns filed by the vendor.

It is necessary to be extremely attentive to detail to ensure that the contract that will be signed accurately represents the terms that have been agreed. This process should involve not only lawyers in agreeing the contract but also tax advisers, who will be aware of the tax implications of any proposed changes to the terms or structure of the deal.

.7. Completion

When the day of completion is over, there will still be things to be done;

- Completion accounts
- Calculation of any deformed consideration
- Negotiation and settlement of any amounts claimed under warranties and indemnities.



Exiting the Technology Business – Flotation

A stock market flotation involves selling a percentage of the company's share capital on one of the stock markets. There are three stock markets in the UK. The largest and best known is the main market of the London Stock Exchange ("LSE") which is generally populated by large companies. Two smaller exchanges are the Alternative Investment Market ("AIM") and PLUS, both of which are specifically designed for smaller companies.

.1. Do You Really Want to Float?

Floating is time-consuming and costly so is not suitable for every business.

Before a decision is made to float the business, discussions should be held with experienced brokers to evaluate the company's prospects of securing sufficient interest from investors to make any flotation successful. We would suggest seeking this advice at least two years before the intended date of float so that any potential issues can be dealt with in good time.

The success of a float will depend not only on the characteristics of the company, but also on market and economic factors at the time of flotation. Investors will only be interested in buying shares in a business if it has secure earning streams and strong growth prospects.

If a business cannot deliver the necessary growth that investors would seek, or it is found to operate in a relatively unattractive sector for investors, a trade sale, where the business is sold to another outside party, might be a more viable option.

.2. Preparing to Float

When preparing to float a business must ensure it is able to comply with the legal and regulatory standards required of a public limited company. It will also need to ensure that its accounting systems are able to produce the information required to prepare annual accounts and reports which comply with the generally accepted accounting principles of the "LSE".

During the preparation period the management team should seek to address any issues which might present a risk for an investor. This will include ensuring all regulatory filings are up to date, outstanding penalties and fines are paid and possible litigation (if any exists) is appropriately resolved.

The aim will be to present the company as an ideal, well run, investment opportunity.

.3. Appointing Professional Advisors

Having the right advisors is a key element to a successful flotation. The management team may have limited experience of the demanding legal, regulatory, financial and marketing processes associated with a flotation and external help, while it is likely to be expensive, will be invaluable for several reasons:

- Using an advisor who provides poor advice could seriously affect a business' ability to attract investors and float successfully;
- In addition a stockbroker will be required to generate interest in the business in the investment community and

- A corporate lawyer will be responsible for the legal due diligence process and for verifying statements in the prospectus and other documents. An accountant will be needed to review and audit the company's finances and perform financial due diligence.

.4. **Choosing the Correct Market**

Choosing the correct market for the company and the size of investment it needs is very important.

12.41. **PLUS**

PLUS is aimed at smaller companies who are looking to raise up to £10 million. The market is regulated, but the requirements are not as stringent as those of AIM or the LSE and flotation and ongoing listing costs are lower. The pool of investors is primarily limited to private investors.

12.42. **AIM**

AIM has a higher profile than PLUS, and has historically generated more interest from the investment community. It is part of LSE, but is a more flexible regulatory environment than the Main Market. AIM listed companies usually attract a wide range of investors, including institutional ones.

There is no minimum percentage of the company's shares which needs to be made available to the market, but if the company has been trading for less than two years at the date of the flotation the existing shareholders cannot sell their shares until at least one year after flotation. A nominated adviser is required at all times which means the ongoing listing costs will be higher than those on PLUS.

12.43. **LSE**

This market is only suitable for the largest of companies. A company listing on the main market needs to have been trading for at least three years and is required to float a minimum of 25 per cent of the company's share capital.

The main market has the widest possible audience of potential investors and the regulatory requirements are correspondingly high as a result. The professional fees and costs of listing on the main market are much higher than those on PLUS or AIM. Admission documents for flotation on the LSE also need to be pre-vetted by the UK Listing Authority.

.5. **Flotation Price**

Deciding on the right price for the business can be one of the most difficult aspects of a flotation. Most companies are valued on a multiple of their historical and forecast profits. A number of factors can influence the pricing decision. If the business is in an exciting, fast-growing sector or is the market leader in its field, investors may be willing to pay a premium for the shares.

.6. **The Flotation Process**

A typical flotation will take a minimum of three months to complete, but could take as long as a year to ensure that everything is in place and the company is ready to go public. For this

reason, it is important to ensure the management team do not allow the flotation to distract from the day-to-day business of running and growing the company.

12.61. Advantages

- Access to capital to enable the development of the business;
- Once shares are traded on an open market they are easier to buy and sell, which will make them more attractive to investors;
- If the management team intend to make acquisitions it is easier to offer shares in the company as consideration instead of, or as an alternative to, cash;
- Offering employees extra incentives, such as share options, when there is a market for the shares is more attractive than offering share options in an unlisted business;
- The greater status afforded to listed companies will raise the profile of the business.

12.62. Disadvantages

- The value of the business may be less than for a trade sale, especially if the company is trading in an unfashionable market;
- The value of the business will become more vulnerable to market fluctuations;
- Only certain businesses are suitable for floating. Good prospects for growth and an impressive management team are needed in order to attract investors;
- The original management team will lose some or all control over the business as they will need to consider the interests of the external shareholders when making decisions;
- The initial costs can be substantial;
- The ongoing costs of listing and complying with the regulatory environment will be high, as will the demands this places on management time;
- Exit may only be for the initial investors, not the management team who may need to be retained.

Acknowledgements

This guide has been compiled by James Cowper LLP in association with Peters Elworthy Moore in Cambridge and Rabjohns LLP in Worcester. All three firms are members of the Kreston International Network of independent accounting firms, which is the 13th largest accounting network in the world, covering 94 countries providing a resource of over 19,500 staff.

Whilst we have endeavoured to ensure that the contents of this document are kept up to date, we would always recommend you seek professional advice from your own advisers before concluding on an action plan.

James Cowper LLP

Our substantial portfolio of technology clients ranges from small entrepreneurial start-ups to established brands. They include businesses involved in biotech and pharmaceuticals, physical sciences, IT and internet related activities. Using our vast experience in this highly specialised sector, we can help guide your business towards a prosperous future.

Firm believers in the power of good communication, we foster strong links with universities and research establishments involved in technology transfer. We also run seminars for interested groups and regularly produce articles and press releases on relevant topics.

Key elements of our services to technology business include corporate finance, taxation and accounting support. Be it negotiating deals on your behalf, project appraisals, strategic planning or finding business angels, we offer an integrated approach based on close working relationships.

Contact Us

Offices

Henley

North Lea House
66 Northfield End
Henley on Thames
Oxfordshire
RG9 2BE
Tel: +44 (0)1491 848500

London

28 Ely Place
London
EC1N 6AA
Tel: +44(0)207 2422088

Newbury

Mill House
Overbridge Square
Hambridge Lane
Newbury
Berkshire
RG14 5UX
Tel: +44 (0)1635 35255

Oxford

Willow Court
7 West Way
Botley
Oxford
OX2 0JB
Tel: +44 (0)1865 200500

Reading

3 Wesley Gate
Queen's Road
Reading
Berkshire
RG1 4AP
Tel: +44 (0)118 959 0261

Southampton

Latimer House
5-7 Cumberland Place
Southampton
SO15 2BH
Tel: +44 (0)2380 221222