The Importance of Fundamentals When Advising SME Business and Individual Clients

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In their role as **trusted financial advisors**, accountants must address a wide range of issues including reduction of tax liabilities, proposed investments and **obtaining finance for SME clients.** In the current climate of economic uncertainty combined with a complex regulatory environment, it can be worthwhile to consider **the fundamentals of business and individual investment decisions**.

For these issues, the fundamentals are:

- ***Reduction of tax liabilities*** – using the few remaining legitimate methods that will minimise tax payments
- ***Proposed investments*** – to provide information on factors that should be investigated in conjunction with advice that clients should obtain from Qualified Investment Advisers (QFAs) and authorised Investment Intermediaries
- ***Obtaining finance for SME clients*** – securing the appropriate type of finance at a minimal cost to the business.

This article presents a summary of the findings from a six year study that analysed the factors associated with SME growth, survival and failure. These findings can **provide insights** for accountants that wish to provide informed investment, tax and funding advice **for individual and SME clients**.

Figure 1: Survival Trends of Distressed SMEs Classified by Amounts of Issued Share Capital (ISC)

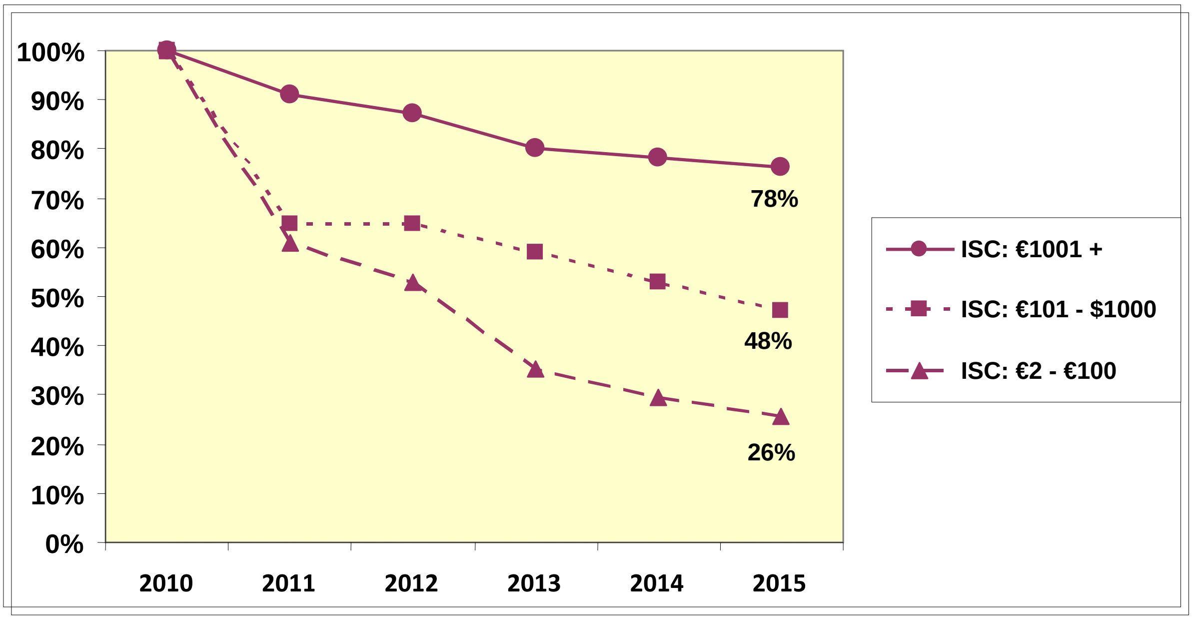

Figure 1 above illustrates the **survival rates of 150 'distressed' SME firms** for the years 2010 – 2015. The firms were categorised as 'distressed' on the grounds that they had a judgement registered against them (for an outstanding debt not paid) in the previous 12 months. These firms were divided into three categories based on levels of equity investment as represented by the amounts of Issued Share Capital (ISC):

- ***Low*** levels of equity funding (ISC: **€2 - €100**)
- ***Medium*** levels of equity funding (ISC: **€101 - €1,000**)
- ***High*** levels of equity funding (ISC: **> €1,001**)

As can be seen from the chart, there are dramatic variations in the survival rates of the companies based on relatively minor differences in the amounts of ISC. **The group of firms with the smallest amounts of ISC (€2 - €100) has the lowest survival rate:** only **26%** of these firms were in existence after six years. 48% of the companies with medium amounts of ISC (€101 - €1,000) had survived after the same six year period. **The highest survival rate (78%) was achieved by the group of firms with the largest amounts of ISC i.e. more than €1,000.** Based on these findings, it can be observed that there is a strong positive correlation between the levels of **<u>equity</u>** (as represented by amounts of ISC) and the **<u>survival rate of SMEs.</u>**

It should be noted that these firms had a judgement registered against them and were experiencing some **form of financial difficulty.** Further extensive **quantitative and qualitative research** was conducted on the characteristics of the companies that survived in spite of having a judgement registered against them. This analysis investigated the **impact of other variables on the survival rate of each group of companies**. It was found that the companies that survived had the following attributes:

- **Asset-backed** – tangible assets with a conservative valuation
- **Revenue streams** – established market with evidence of demand for product/service
- **Cash generating** – based on efficient working capital management
- **Profitable** – controllable costs with no excessive salaries for directors
- **Experienced directors** – expertise in specific business sector or relevant management skills
- **Low levels of gearing** – reduced short-term fixed financial commitments.

Experienced accounting practitioners will recognise these attributes as **good fundamental characteristics**. However, it is interesting to note that adherence to basic business principles ensured that these companies survived **in spite of financial difficulties** as evidenced by the registration of a judgment for non-payment of a debt.

Practitioners will also have noted that many of these **characteristics are interlinked**. For instance, experienced directors will **maximise** revenues, profits and **cash flows by efficient management of costs and working capital**. They will also **minimise bank** and other external sources of **borrowings** in order to reduce the impact of interest costs on profits and will be aware of the **importance of equity finance in order to ensure long-term financial stability**.

Obtaining equity funding is very difficult for Irish SMEs. In a report commissioned by the Department of Finance in 2014, the **ESRI** have noted that the main **Government and EU approved** tax based mechanism available for **SMEs** to raise **equity finance** is the Employment Incentive and Investment **(EII) scheme**.

Currently, this enables **most trading SMEs to raise up to €15 million** subject to a maximum of €5 million per year.

Individuals may invest up to €150,000 per annum and can obtain **30% tax relief** in the year that the investment is made with a further **10% received at the end of a four year period**[i]. This compares favourably with current low levels of deposit interest rates.

Note that, in return for their investment, EIIS investors are normally issued with 'B' class (**non-voting**) equity shares. This means that **the original shareholders do not dilute their degree of ownership and control**.

The **ESRI** report also noted that the **EII scheme** provides a **transparent and tax efficient method for SME equity funding** to be placed on a secure basis in a way that can benefit both the firm and its original investors. **Individual clients** that wish to **reduce their tax liabilities** can also do so by availing of this Government backed scheme.

Naturally, accountants must always insist that **clients should seek professional investment advice from QFAs and authorised Investment Intermediaries**. Furthermore, it is recommended that accountants should point out that **in order to minimise risk, SME firms should have sound fundamentals** (asset-backed with consistent revenues and net cash flows, low levels of gearing etc.).

<u>CONCLUSION</u>

By adhering to fundamental principles, accountants can **provide individual clients with information regarding a legitimate means of tax reduction and a reasonably high return on capital with minimal levels of risk**. In order to **provide <u>value-added</u> advice for SME clients, accountants should create awareness of the various methods available to obtain finance** and should emphasise **the importance of equity and other business fundamentals** for **<u>business survival.</u>**

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[i] For full details of the EII scheme, please consult with the Income Tax information document (IT 55 - The Employment and Investment Incentive (EII) - Relief for Investment in Corporate Trades) available at: http://www.revenue.ie/en/tax/it/leaflets/it55.html