Making local food work

CO-OPERATIVES UK

Simply FINANCE

A comprehensive guide to the different options for financing a community enterprise

1st Edition June 2011

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Co-operatives UK is the national trade body that campaigns for co-operation and works to promote, develop and unite co-operative enterprises. Co-operatives UK aims to bring together all those with a passion and interest in co-operative action.

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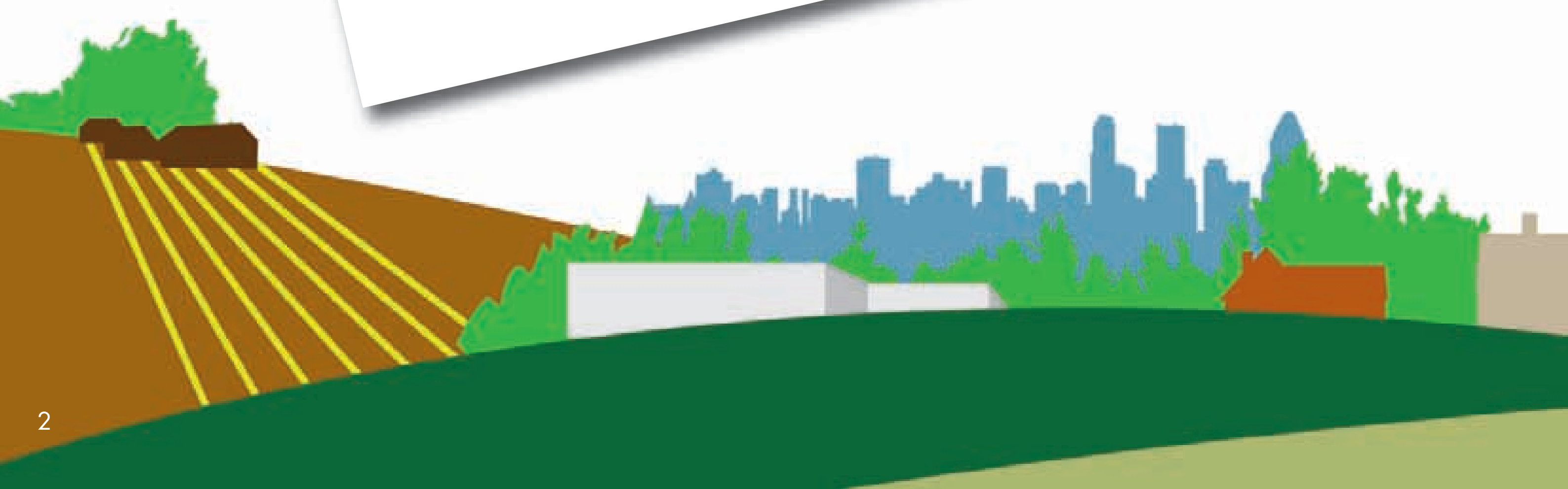

Foreword

Money may make the world go round, but if you are trying to make the world a better place it can seem to be notable by its absence. So many would-be social entrepreneurs founder on this first step of securing the funds they need to launch a project.

This guide will go some way towards easing that difficulty. There has been an enormous amount of innovation and development in the field of finance for social and community enterprises in the last decade, and it is about time the findings were brought together in an informative and practical way.

This guide does not offer theories or idealistic dreams, but simply describes the tools that are available and offers beginners' guides on how to use them. That means there is no longer any excuse for sitting on the sidelines, or leaving the field to profit driven business. You have here everything you need to get stuck in to revitalising your community.

So often, people say 'I am keen to be involved in community enterprise, but I don't know anything about finance / money / economics'. This is a real obstacle – it's the one thing that every person involved in the running of a community enterprise does need to know a bit about. Let's take the knowledge in this guide and spread it around as widely as possible, to rebuild the confidence of the people rebuilding our society.

Peter Gotham
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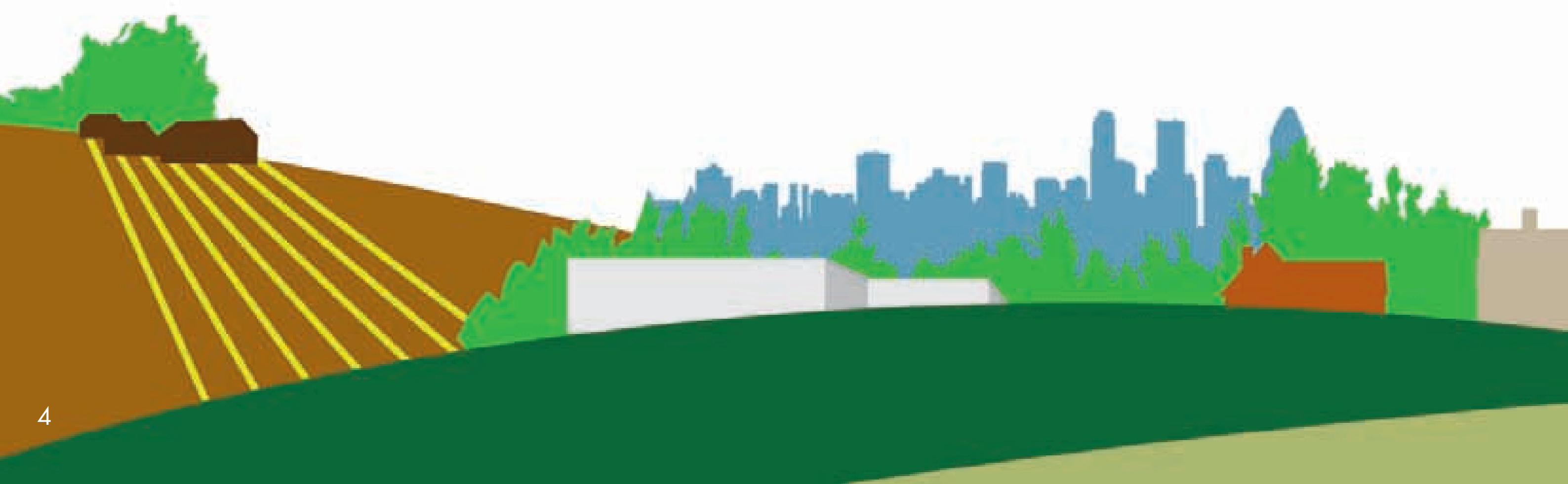
London

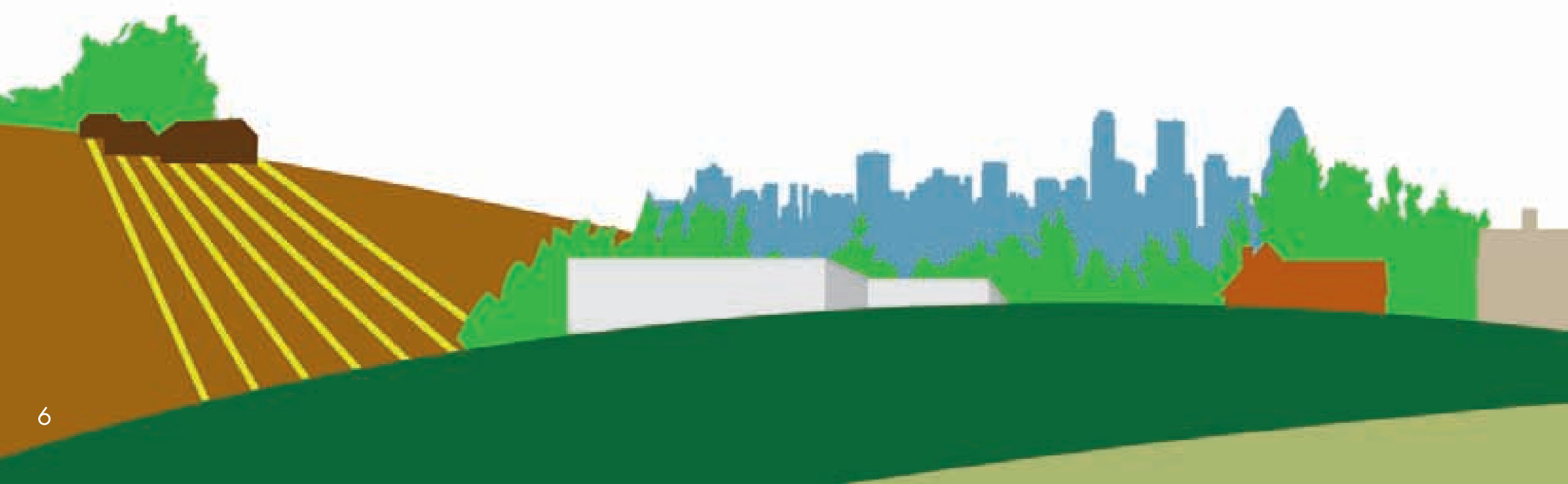
Peter Gotham formed Gotham & Co. in 1981 to develop the services he had been providing to small organisations on a voluntary basis for over 10 years.

As well as lecturing and writing on finance for non-professionals, Peter is currently the Chair of the Charities and Voluntary Sector Group on the Institute of Chartered Accountants in England and Wales.

Peter is also a Visiting Fellow at the Cass Centre for Charity Effectiveness at City University, London.

Contents





Introduction to the Guide

1

Co-operatives UK is the national trade body that campaigns for co-operation and works to promote, develop and unite co-operative enterprises. Co-operatives UK has a unique role as a trade association for co-operatives and aims to bring together all those with a passion and interest in co-operative action.

Its core role is to:

- provide a strategic voice for co-operation;
- work to safeguard and increase awareness and understanding of co-operative values and principles;
- support the development and growth of co-operatives; and
- be the centre of excellence for the provision of services to co-operatives.

This guide is written for development professionals in England involved in supporting new and existing organisations in the social and community enterprise sector, and also for self-supporting individuals working in those organisations. Anyone who is seeking to bring finance together with a new enterprise, or an existing enterprise that is growing or diversifying, will find this guide relevant.

This guide is funded by the Big Lottery Fund which covers England only. As such this guide may not be relevant to the financial regulations in Scotland and Wales.

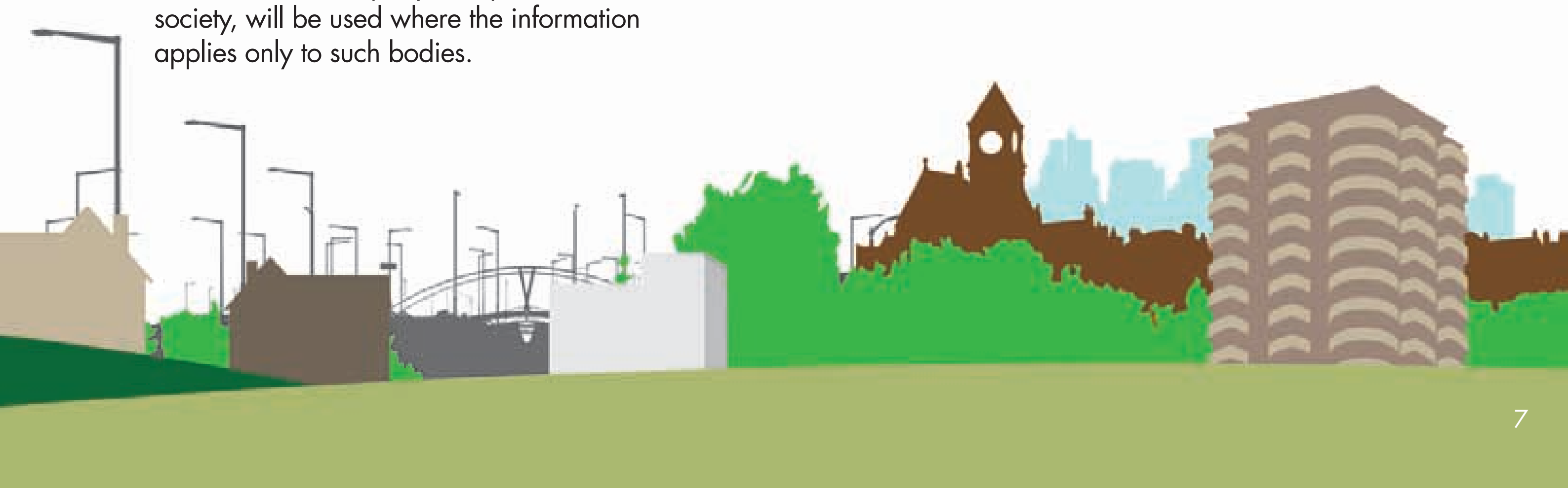
Throughout this guide, we will refer only to the 'organisation', as it will apply to a range of different companies, societies and unincorporated bodies. More specific terms, such as company, co-operative or society, will be used where the information applies only to such bodies.

About finance

What do we mean by finance? It is liquid capital resources – lump sums of money that can quickly and easily be deployed for whatever purposes are required. A clear vision of the future success of an organisation motivates supporters to provide resources. The resources are then applied to make that vision of the future possible.

Finance can be neglected because it seems dry, or complicated, or morally compromised. But it need be none of those things. Think of it instead as the fertiliser that, when sprinkled on to a lacklustre enterprise, allows it to spring into life and productivity. Finance stems from the natural human impulse to collaborate and pool resources. Irresponsible and unaccountable enterprises have annexed this impulse for their purposes; we can and should reclaim it.

No organisation is too small, or too simple, or too homespun, not to require finance. Sometimes the vital boost that an organisation receives at the outset goes by other names, or does not take a monetary form. It is still a necessary resource, allocated in order to turn potential into reality.



Finance for co-operatives and community enterprises is in many ways similar to that for conventional enterprises: the language, the concepts and the maths are essentially the same. The difference is that it is upside down. In conventional enterprises, investment and ownership dictate the activities of the business; in the social and community enterprise sector it is the stakeholders – the people most affected by the enterprise – that are in control, determining the direction of the organisation and the terms on which investment is raised. This simple, but subtle, reversal of power provides the context for all the finance options discussed here.

What this guide does

You are the right person to be reading this guide if you are involved with a project that wants to be more, or better, than it presently is. In order to make that leap something extra may need to be brought in from outside the organisation. This guide:

- provides a foundation for understanding the role played by finance in enterprises;
- describes the main forms of finance and how they are accessed;
- provides some templates and standard conditions to enable you to reach honest and fair agreements with providers of finance;
- identifies some of the main tax and accounting issues, in so far as tax and accounting are affected by the way in which you finance your enterprise.

Use the contents to identify the key issues that you need advice on, and look out for cross references that will direct you to other, linked, chapters of the guide. There are flowcharts to help you navigate, but if you are in doubt begin with chapter 2, which will describe what is needed to be ready for finance.

As this is a guide, use the content to help understand and formulate your ideas, then seek the appropriate professional legal and financial advice – as highlighted in the appendices.

Throughout this document we refer to Co-operative and Community Benefit Societies, rather than Industrial and Provident Societies. This is on the assumption that legislation introduced in 2010 will facilitate a change in title. To the best of Co-operatives UK's knowledge this will be commenced in the autumn of 2011.

Acknowledgements

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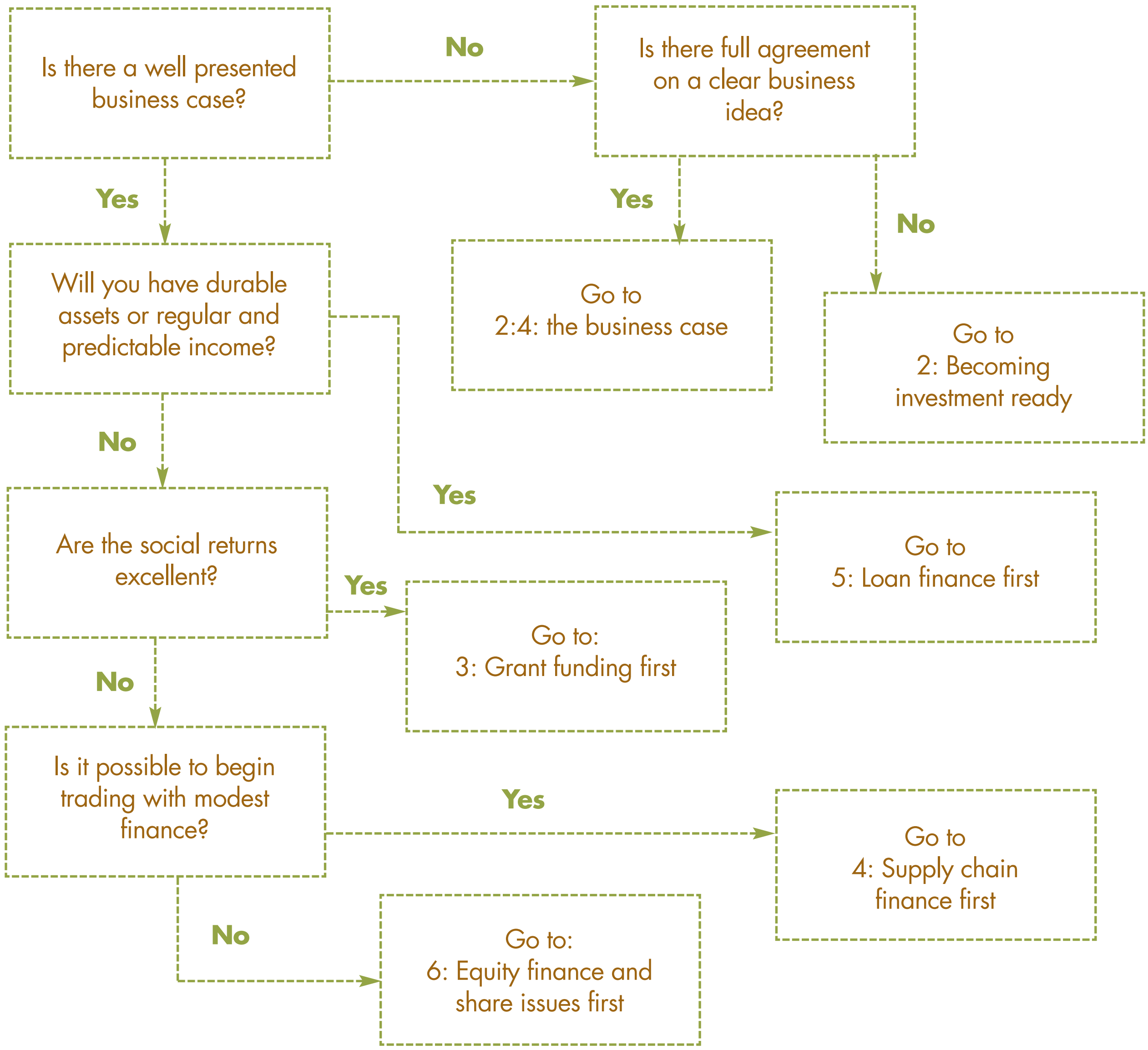
Your route through Chapter Two

These flowcharts may help you find the most obvious solutions to your finance needs; however, they won't direct you to all the sections that are of relevance to you, so don't rely on them for all the answers.



2 Becoming 'investment ready'

All businesses (or "enterprises") have to make a case for the finance that they require. Not every idea can be supported, and the key to ensuring that funders and investors are drawn to one rather than another is communicating its strengths and relevance clearly and effectively. The precondition for that is that the participants in the organisation understand it clearly themselves. This is what makes an organisation 'investment ready' – a term most often employed in relation to equity investment, but of relevance to organisations that hope to borrow or receive a grant as well.

'Investment readiness' is a term used to describe how well you answer investors' questions about the returns they will gain. First used in an Australian government report, it was defined as 'meeting the fundamental requirements to be attractive to external investors'.

Radical Routes, with its investment society Rootstock, is a good example of a co-operative that clearly offers a blended return to investors. People who invest in it get a financial return (interest, presently around 3%). But there is also a social return, as Radical Routes uses the funds to start housing co-operatives, social centres and businesses that all campaign for peace, social justice and ecological sustainability.

Business is often defined as a repeated series of voluntary exchanges. Social enterprises and co-operatives are businesses, but they are guided by a shared purpose – a set of values, or aims, that go beyond simply making money. These two features mean that they provide some 'return on investment':

- there is an intention to make a profit (each year, the value of the organisation is greater than the year before) which investors may be able to share in;
- there is a benefit to the people most affected by it (sometimes called 'the social return').

These two kinds of 'return' are the basis of the story they have to tell about their intended future success.

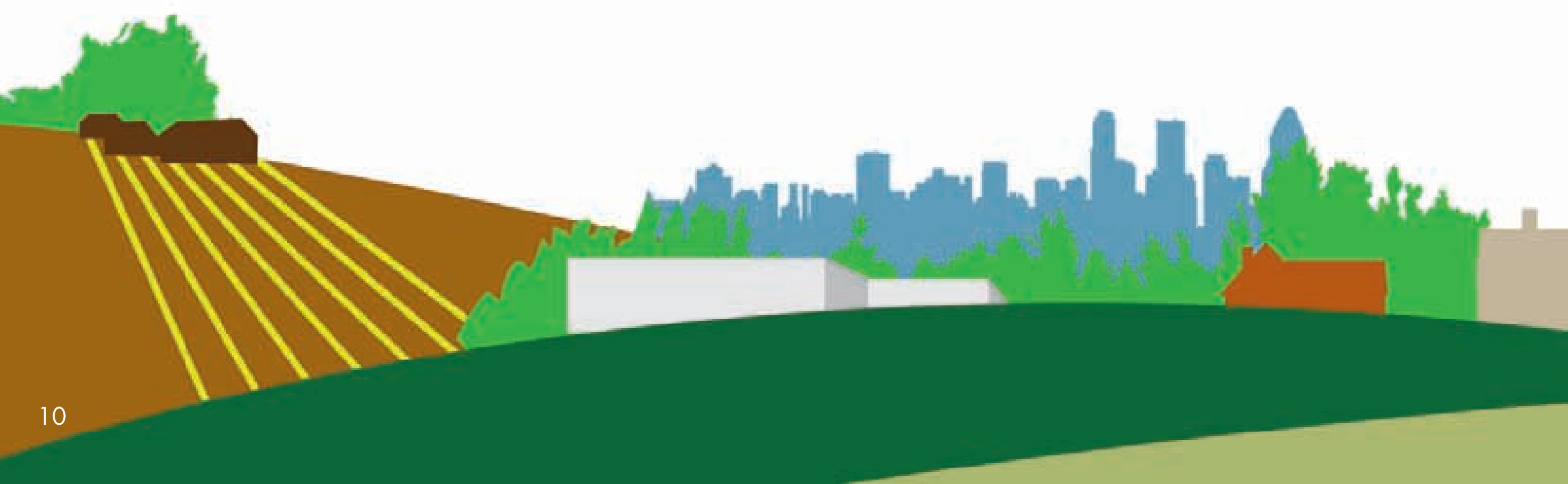
That's the essence of what finance is about: your good idea has outputs – it is productive – and so people who want to share in those outputs in some way are willing to put some of their resources in to make it happen. There are always alternative places for investment to go: you are bound to be asked, "Will this really lead to the benefits that we are seeking? Is this the best place for our resources?"

2.1: Returns

In any business, there is a balance between financial and social returns:

- if your returns are principally social, with few if any financial returns, the emphasis is likely to be mostly on grant funding, small scale investment from the most closely involved stakeholders, and in-kind support;
- if there are significant financial returns, with subtle or localised social returns, it may be more appropriate to look at loans and share issues.

Maybe your enterprise will excel in both: but while a 'blended return' is the objective in theory, there will always be choices and priorities, and it is as well to think through what they will really be in practice.



Having a focus on social benefits does not prevent an organisation from putting a great deal of time and resources into maintaining profitability. Socially driven businesses form a broad spectrum, ranging from those that are outwardly highly commercial, to those that are more charitable and do not expect to compete for business.

2.2: Risk

The other spectrum on which your organisation must position itself is that of low or high risks and returns. Risk is more than just uncertainty; it is the unavoidable, inherent uncertainty of a volatile or changing marketplace, and the extent to which those unavoidable uncertainties could impact on your organisation. There is no excuse for failing to investigate and gather information on critical issues before the organisation starts trading, but if that still leaves you not knowing exactly what kind of market will exist for your product in two years time, that is risk.

When seeking finance, it helps if there are enough returns to offset that risk. A venture capitalist (social venture or financial venture) is unlikely to get enough return out of a low risk activity for it to be worthwhile. A cautious banker must preserve their capital, and mainstream donors want predictable outcomes; they accept that the consequence is modest, limited returns.

Risk should be considered at an early stage in the process simply because it will, to a large degree, shape the experience of the participants. A risky enterprise is stressful, exciting, high pressure and with the potential for both high returns and disappointment. A low risk enterprise is confined to well trodden paths, rulebound, safe and reassuring. They reward people of very different temperaments, and anyone getting drawn into a new business activity has a right to know the level of risk involved first. Your founding team should have an honest discussion about the level of risk that they are prepared to manage.

2.3: Purpose and focus

But maybe there is a more fundamental question to be examined at this stage. Whether it is a completely new organisation, or a new product or activity for an existing organisation, are you actually clear what the business idea is?

A mission statement can be very helpful; it should sum up in just one sentence the area in which the business works, the distinctive methods or values it employs, the expected results of the activity, and the wider impact that is expected. Some organisations have a statement of aims that serves a similar purpose. However, bold statements of good intentions can sometimes conceal confusion about the actual plan of action. In addition to this statement

Social returns often rely on a 'hypothesis of change' – a belief that if we do x, then it will deliver social benefit y. It helps to explain this hypothesis clearly, and provide evidence to support it.

Social Return on Investment (SROI) is a detailed methodology for quantifying the social benefits from an activity. However, many organisations use more approximate or qualitative measures for preparing 'social accounts'.

A risk register is helpful: brainstorm a list of possible risks, and then for each one assess its likelihood, severity, and mitigation (actions that can be taken to protect the organisation from it).

Many social enterprises have an altruistic goal – benefiting others – while co-operatives stress self-help, and seek to benefit the community or communities to which its founders belong. Social co-operatives (a term more familiar elsewhere in Europe than here, but which describes a growing number of enterprises) combine the two - a community collectively takes action for the good of all.

If you are introducing something quite new, you may have a 'unique selling proposition': there is an unmet need that you can meet exceptionally well.

'Impacts' means the changes beyond the boundaries of your organisation which you want to see as a result of your activities; 'Aims' is a similar term – it refers to the most ambitious of your goals and objectives, those that you cannot set a deadline for and may in fact never be fully completed.

of long term principles, there should be a description of the specific transaction that is intended to advance the mission of the business here and now. It should cover:

- the product;
- the benefit to the customer, compared to other similar products;
- the distinctive features of the process by which the product is prepared;
- the raw materials, or inputs, from which the product is made;
- the ways in which these things contribute to the mission.

It might be important to describe the idea in relation to the people that the organisation serves. The relationship between the organisation and its key stakeholders (which might include customers, suppliers, workers, or local residents) may make a crucial contribution to the productive process, or actually be a benefit of the product being supplied.

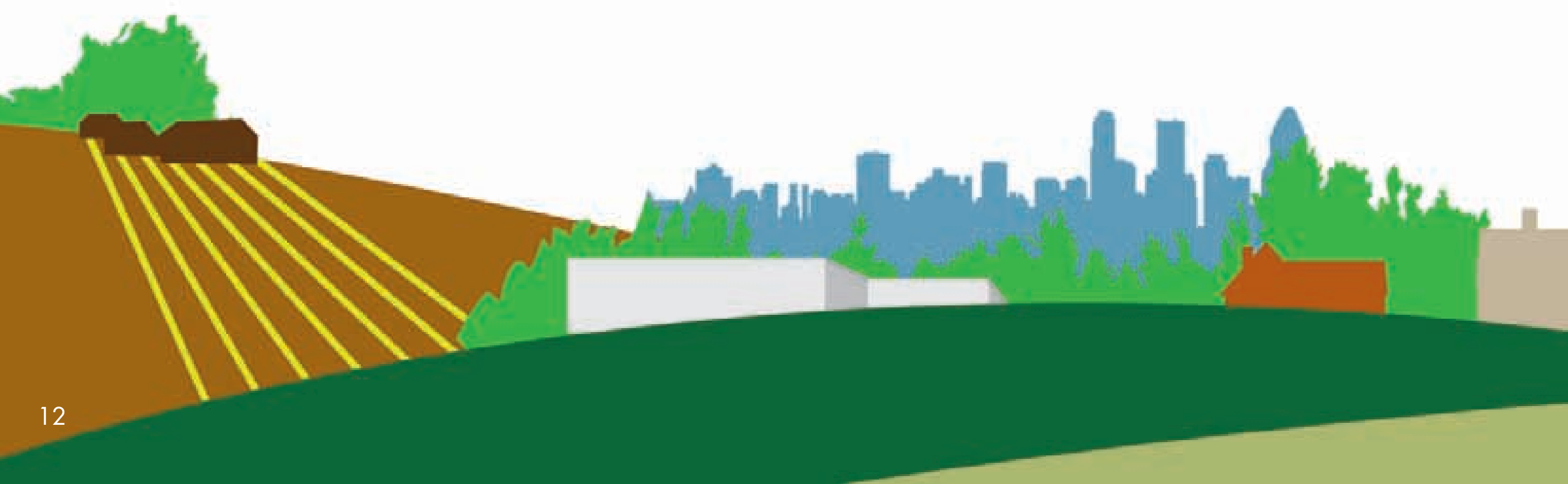
You will find it easier if you can refer to a similar, successful organisation elsewhere and explain how you are learning from their example – it is good to be a bit innovative and original, certainly, but well trodden paths are usually well trodden for a good reason.

A common problem at this stage is that it becomes clear that what was intended to be one business is actually two or more businesses bundled up together.
If you are planning to collect kitchen waste and place it in a digester to create compost and biogas, these are arguably two products from one business. But if you are then wanting to sell the compost alongside a range of other gardening products in a retail outlet; or collect and recycle waste timber alongside the kitchen waste; then you are actually trying to start two businesses at the same time, and that is more than twice as hard.

Brand new businesses are time consuming and vulnerable. Even if you think you are part of a team that has the resources to develop more than one at the same time, you should treat each one separately and ensure that its needs can be independently met.

2.4: The business case

This leads us to how you formally put these ideas down on paper, in the form of a business case or business plan – or, indeed, both. The difference between the two is subtle, but in general the business case deals with whether or not you should carry out a business activity, while a business plan explains how you should best carry out a business activity. The business case can be a brief provided by the key stakeholders in an organisation so that project managers and staff can write a full business plan.



Both have to address the question of finance and returns. A business case will ask: "what are the returns from this activity? How do they compare to the returns from other possible activities, or no activity at all? Are they sufficient to justify the resources required – the finance?".
A business plan, by contrast, will look at finance in a slightly different way: "what are the optimum resources to start this business activity with, and how can they be used most efficiently? Where can they best be obtained from, and what terms can we expect to get? What returns are expected, and when? How do we maximise them, minimise risks, and prepare the business for future activities?".

For the purposes of this guide, the business case is of most relevance. The business case may well be principally internal; it is a decision making tool, used before committing to action to make sure that it meets the objectives of the business. However, it can also be used to introduce sources of finance to the proposal.

2.5: Scale

The scale of this preparatory work should be in proportion to the project: for a hundred square metre community garden, you should cut to the chase briefly and succinctly, ignoring the bits that are of less relevance. For a hundred acre organic farm and research establishment, you should expect to have to justify in detail the enormous commitment you are expecting all concerned to make.

Scale is often misleading, though. Everyone assumes that a larger project is more difficult than a smaller one – but that isn't always the case. The ease of a project is more to do with making good use of available capacity, and not calling on capacity that is unavailable.

So, consider a choice between two tools: one that is cheap to buy and run, but slow to operate; and one that is expensive but very productive. Neither one is 'better' than the other – it depends on the size of the market that the business is meant to serve. A handful of people would meet their needs best with the simple device; the more expensive tool would burden the group with obligations while never working at its full capacity. There may not be appropriate tools for certain sizes of market – the only way to be profitable is to aim higher or lower.

2.6: Sufficient capitalisation

It is a commonplace observation that social enterprises, co-operatives and community enterprises have suffered in the past from being undercapitalised: working with old, broken tools, in cramped premises, with inadequate training and no working capital with which to establish the business. If there is one thing you should get from this guide, it is how to avoid that plight.

Working capital is the funds available to spend less any bills due for payment; it is an essential resource to manage cash flow challenges.

Business case contents	Business plan contents
Mission statement.	
A summary of the business idea.	
Strategic purpose: what are the expected outcomes, and what are the needs that are being met?	SMART objectives (specific, measurable, achievable, relevant and time bound; you can add ethical and resourced or rewarding to make them SMARTER!)
Choices: what other options for action were considered and why were they rejected?	Background, history and context: where did this idea come from?
Focus: what are the assumptions being made, and the constraints that are accepted? Were the size, scale and complexity within limits?	Supporters: who else thinks this is a good idea, and what are they committed to putting into it?
Dependencies: what are the requirements for personnel, and what other agencies need to support the idea?	Personnel: who are the people who will implement the plan, and why do you think they are the right people?
Area of work: PESTLE analysis (political, economic, social, technological, legal and ecological) can help you assess what are the relevant features of the business environment.	
Risk analysis: what could go wrong, how severe, how likely and how likely are these risks?	
Market strategy: what market research and analysis has been carried out, and what marketing message and activity is required?	
Workload: what existing capacity is there, and where is new capacity needed? What is the timetable, and the main milestones on the way?	Operations Plan: SWOT (strengths, weaknesses, opportunities, threats) can be used to identify your least-resistance route, and define phases and critical paths.
Social returns: what are the returns expected from this activity?	Evaluation and social accounting: how will you measure and report the social benefits you expect to get?
Resources: what is needed to get this activity underway?	Budget: how will you raise the finance for the resources needed at startup?
Pinchpoints: when do you expect resource flows to be at their tightest?	Cashflow analysis: usually a spreadsheet showing the first two years month by month.
Return on investment: an analysis of how much profit is generated by the activity and over what period of time. A spreadsheet can combine this with initial investment to generate a figure for 'internal rate of return' (see 6.7).	Profit and loss: typically year by year, and showing not just cash flow but depreciation, invoices, capital repayments and other 'hidden' value. Some investors may require balance sheets in addition.

However, there is a strong argument that overcapitalisation is a risk also. All capital comes with obligations – the need to make a return. If too much of the turnover is being put into rewarding investors, the business will lack reserves for future development. The consequences of borrowing too much and being unable to keep up repayments if sales slip are obvious enough (see chapter 5.2) but something similar can happen with equity investment if investors put pressure on the organisation to deliver a short term return on their investment. The tail can begin to wag the dog.

There is also the danger of the fool's paradise: it is a great relief when starting a business to know that – as many would suggest – you have enough working capital to cover running costs for eighteen months while sales build up. But such a cosy security blanket can cut you off from the reality of the market and the needs of your customers. You may not realise that there is inadequate demand for your product, or that your processes are inefficient, until it is too late to change direction. Finance is vital, the lifeblood of any business, but it is not a substitute for market intelligence and shouldn't be used as such.

2.7: Diverse connections

It is usually safe to assume that finance for any organisation will be of many different sorts – and almost always could feature at least a small contribution from each of the four categories in the next chapter. Grants, loans, supply chain and equity can be very effectively combined, and if you are seeking to finance your business development using some but not all of these, you are missing out on opportunities – perhaps small, but worthwhile.

Last of all, it is important not to regard finance as simply a functional need for an organisation. It is potentially much more than that: you can weave a supportive community around your organisation, and build co-operative relationships not just inside but outside the organisation.

Funders, lenders and investors are not just there to hand over a cheque but may be keen to be part of a conversation about your project: as it develops, they may provide you with contacts, advice, custom and further funds. All that is required is to treat them with respect, honesty and courtesy.

Profits and cash surpluses are not the same thing. Cash in the bank may be 'spoken for'; profits may be present in assets that can't be easily converted into cash. A healthy business has both available cash and net profits.

Permaculture is an approach to project design that among other things stresses multiple elements meeting each need, and multiple needs met by each element. This can be applied to the financing of an enterprise to create a robust 'web' of finance.

3 Grant funding

It is understandable that most people seeking finance in the social and community enterprise sector will look first at the availability of grant funding. Although the forms and features of grant funding have changed substantially in recent years, they remain crucial opportunities to turn good prospects of social return into the liquid funds needed to get a project underway. The plethora of organisations offering grants, and the complex application processes and criteria, can be daunting at first; but there are also many organisations that provide excellent training and advice on how to make sense of it all.

Some funders are known for paying grants months in arrears. The grant then has to be combined with some other form of finance (typically a loan) to cover the cashflow.

There is a distinction between outputs, outcomes and impacts: outputs are what you actually produce, outcomes are the direct, immediate results, and impacts are the changes that your outputs and outcomes contribute to as one factor among many.

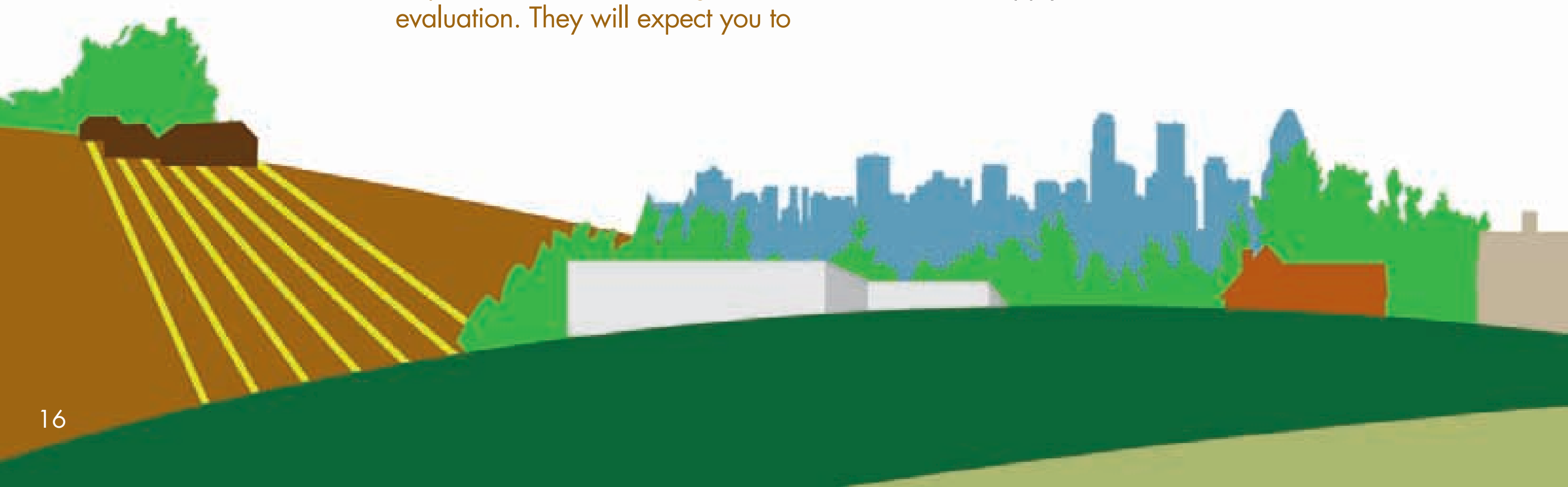
3.1: The grant contract

There are many different relationships being adopted between funders and recipients these days, only some of which fit the neat description of 'grant funding'. Some agencies will describe ongoing support for a service as a 'service level agreement' or some other form of regular, results-based contract. If this is still a form of grant (and there is a grey area between grants and contracts for services) it will only provide finance for an organisation if it is paid in advance of costs being incurred.

Ideally, a grant is given – possibly in instalments, but at least partly in advance – with some expectation as regards the activities that it will be used for (as well as timetables and milestones) but without any obligation regarding the results of those activities. It does not have to be paid back, and if you have done what you said you would do, the funder accepts the risk that the consequences may not be all that were hoped for. That having been said:

- most funders will have some requirements on monitoring and evaluation. They will expect you to change direction if monitoring reveals that outcomes are not being achieved, and if nothing else use a final evaluation to learn from the experience;
- there are funders offering support that can be 'clawed back' if certain targets are not met. This may be described as grant funding, but it is in many respects closer to a service contract. It may provide some cash flow benefits if it is paid in advance;
- if you have departed from the project as it was described to the funder, or otherwise broken an agreement between you, they can demand repayment.

There will very often be a contract to be signed, obliging the recipient to account for expenditure, conduct themselves appropriately, use funds with regard to best value and so on, but these are to do with honesty and transparency: in terms of what is achieved, the funder is not assured of getting anything in return. That is why it is different to making a sale, and why it is among the most highly prized forms of finance. It's also why it is always in short supply.



3.2: Types of grant funding

Grants are provided for so many different purposes that many enterprises – even those that are relatively commercial – may have the opportunity to apply for one. For this reason, they are always worth evaluating as part of the finance jigsaw. However, to largely or entirely fund a project with grant funding is another matter altogether. You have to be clear that the potential social returns are exceptional, and the financial returns unavoidably slender. A trading business often has to work much harder than a voluntary organisation to justify its claim on funds.

Grants may cover either capital or revenue. Capital grants provide an organisation with funds to secure buildings, vehicles or other capital items. Revenue, on the other hand, is not intended for durable items but instead should cover labour, consumables and other short term costs. Some programmes may allow a mix of both sorts of funding, but there will often be a limit placed on the capital component.

Revenue grants can also be broken down into core and project funding. Core funding is usually non-specific, and so can cover the guts of the enterprises operation. It will pay for overheads, administration, development; the basic needs of the enterprise. It may well be sought, and paid, year by year; but sometimes it will be guaranteed for several years at a time. Project funding is more specific. It can be attracted by describing to the funder a particular piece of work, that can be carried out quite separately to the day to day activities of the enterprise. This is particularly helpful to a trading organisation, as you can avoid having to make grand claims for the social benefits of your trade, and instead focus on a project which is more obviously charitable in nature.

The risk is that the project may become a burden on the rest of the organisation, effectively taking a subsidy from trading activity. That may be what you want, but it certainly isn't something that should happen by accident. 'Full cost recovery' describes the (potentially quite complex) process of identifying all the things that your enterprise does that assist the project, and allocating an appropriate share of their costs to the project budget. For example, if each year you pay an accountant £300 to prepare accounts, and during the year that the project is underway it accounts for 10% of the organisation's turnover, then an appropriate allocation may be to include £30 for accountancy in the funding application. That way, you make sure that if you get funding, it covers all the costs – not just the obvious ones.

If funding is available only for 'charitable purposes', you may not need to be a registered charity. Funded activities should fall under one or more of the 'heads' (types) of charity. For more information on this, see the companion guide Simply Legal.

3.3: Before you apply

Some crucial questions to ask before filling in a grant application:

- do they fund organisations like yours? Many funders will only give to registered charities, and others only to organisations with charitable objects; some require non-profit distribution clauses that would rule out payments

from profits to members or investors. An asset lock in the governing document may be needed to ensure that proceeds on winding up go to an equally charitable or non-profit distributing body;

- is it the right grant for you? Many grant applications are rejected because the applicant did not check what the funder would and wouldn't put money into. Almost all funders will provide either a list of excluded activities, or a list of activities that they are willing to support;
- does what you are asking for fit with what you want to do? There is rarely an exact match between what you want funded and what they want to fund, but be cautious about adapting your plans to meet their criteria. It is one thing to trim your ambitions, but quite another to embark on work that is not part of your mission or purpose;
- do you have the capacity? If you would have to scale up, buy in additional skills, invest heavily in new resources, or ask staff to work harder than they are already doing, you may be overstretching yourselves. Of course, a grant can be used to build up an organisation: but you should be honest about the cost of the reorganisation, and ability of the present team to manage it.

If funding suits your activity, but is limited to registered charities, there may be a charity that will act as your partner, or simply as a conduit. Try asking your local Council for Voluntary Service for assistance.

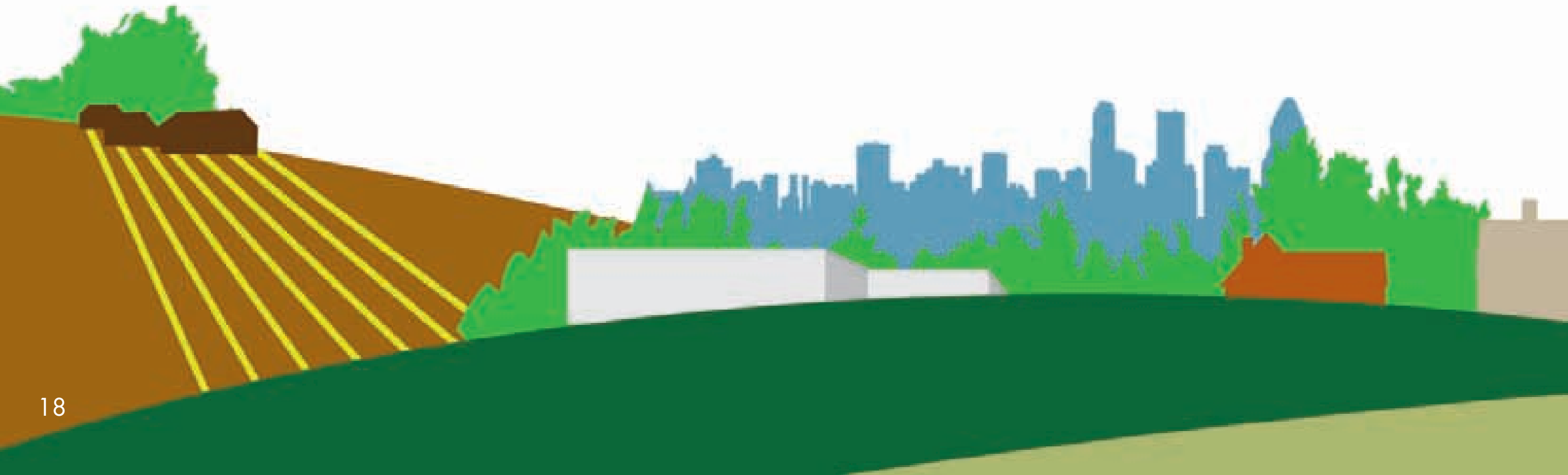
If you are unsure whether your organisation or activity is eligible for a particular grant, it is always worth phoning the funder to discuss it before you spend valuable time on complex applications. If you tell the funder what you are trying to achieve then they will be able to tell you whether any of their funding streams are appropriate and still available.

3.4: State Aid

The rules of the European single market make State Aid a potentially tricky area. No state within Europe is meant to give its businesses a competitive advantage by subsidising their trading beyond a specified level. State Aid rules definitely don't apply if:

- the recipient couldn't be said to be a business, as there is no real trading; or
- the grant doesn't favour certain goods or services; or
- the grant is not ultimately provided from state resources; or
- the grant couldn't possibly distort or threaten to distort competition; or
- the grant couldn't possibly affect trade between Member States.

However, these are all potentially hard to prove beyond doubt: there are many other exemptions, such as support for female entrepreneurs, some support for small businesses, environmental initiatives, which are too complex to go into here. More commonly, funders will rely on the blanket 'de minimis' provisions – in other words, the level at which State Aid is deemed too small to make a difference. Current levels are ⇔200,000 in any three year period, or a percentage of the eligible funding that may vary from region to region.



3.5: Sponsorship

Sponsorship deals occupy a grey area between trade and grants; many grant funders will ask recipients to acknowledge their support, and there is a fine line between this and more commercial sponsorship arrangements.

Where there is an exchange of this sort, you need to think through the compatibility of the brands; in many cases, the donor's brand will enhance yours and you will benefit from the association and the implicit endorsement. In others, though, the ethics, reputation or record of the sponsor may be incompatible with the brand you are trying to establish.

Because sponsorship is a trade rather than a simple donation, it can give rise to VAT and other tax issues.

3.6: Looking for grants

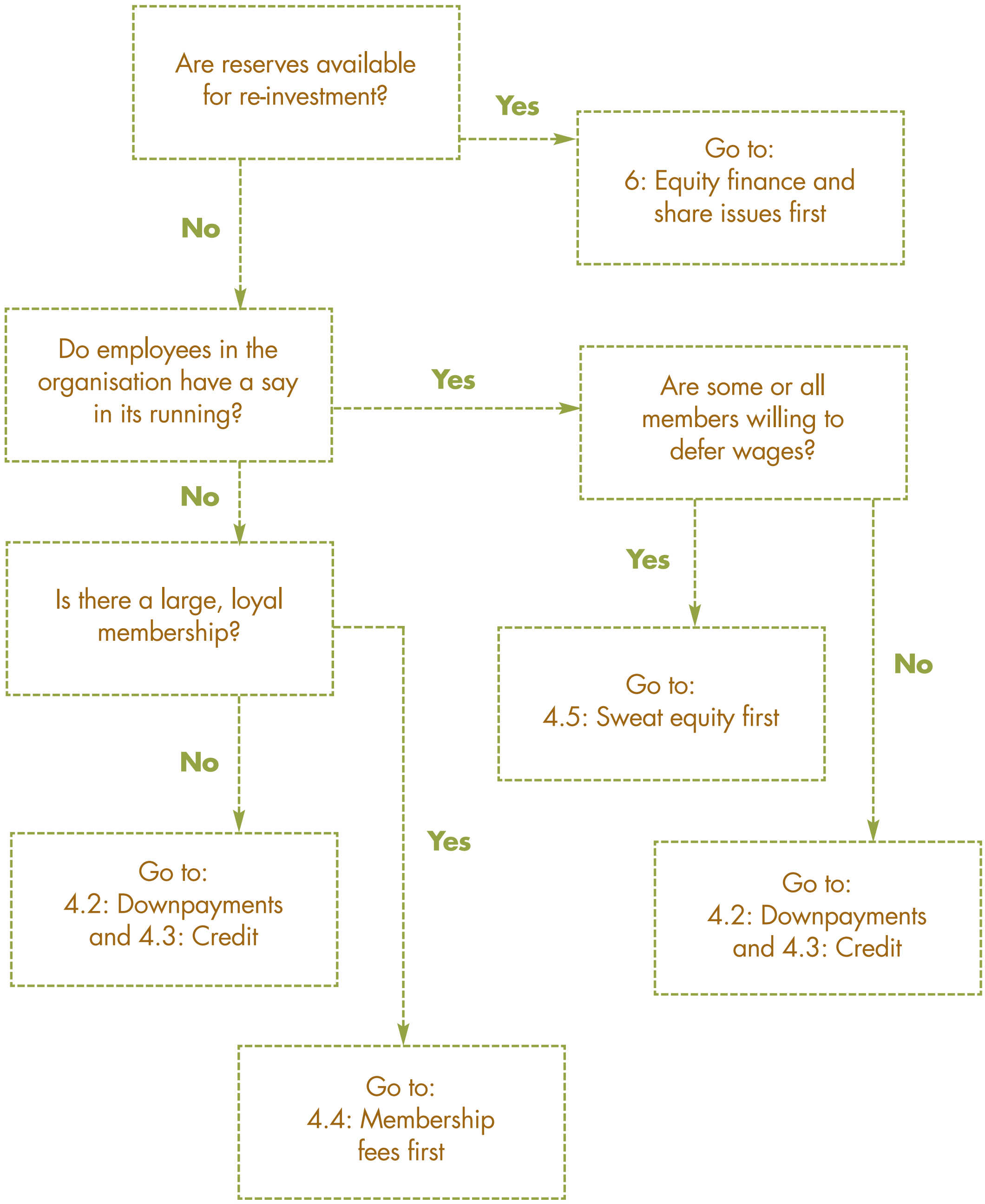
Grant seeking is a notoriously inexact business – some grants are much better advertised than others. However, you can prevent your search taking up too much time by approaching a few key sources:

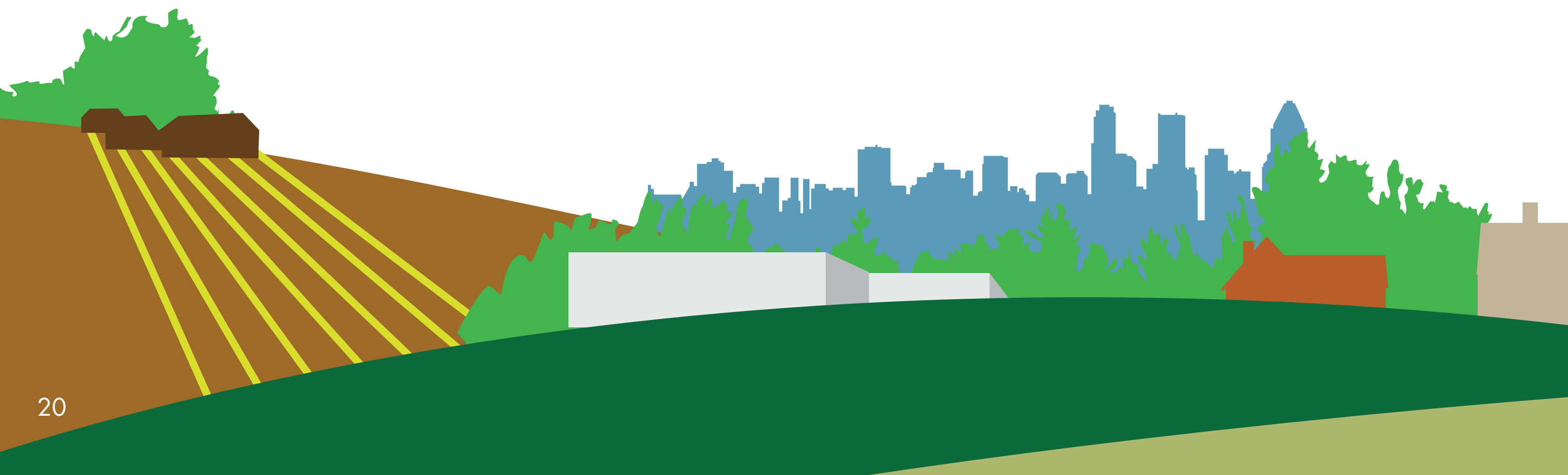
- your local co-operative development body, or social enterprise advisor;
- local authorities usually have officers involved in regeneration or economic development whose job it is to keep track of grant funding;
- local Councils for Voluntary Service should definitely be consulted, particularly for more charitable funding. They will often be able to provide access to the 'funderfinder' or 'grantfinder' databases;
- in rural areas, Community Councils can be very helpful;
- look out for training courses on writing grant applications;
- approach local businesses for sponsorship, particularly those that are large and well established and unlikely to regard you as any sort of competition.

Many local authorities have a European Funding Officer who can give further advice on this.

GOCO, a co-operative seeking to run rail and bus services, was fortunate enough to obtain a grant from the Co-operative Fund to carry out a feasibility study. A condition of the Co-operative Group's grant was that the Co-operative Group's logo should appear on all publicity. In practice this suited both parties: it enhanced the credibility of Goco, while providing tangible evidence of the Co-operative Group's support to emerging community enterprise.

Your route through Chapter Four





Supply chain finance

4

This chapter describes ways in which the trading relationships that you are involved in can actually be a source of finance for your growth. The goods and services that businesses buy and sell have to be paid for; but paying as late as possible, and receiving payment as early as possible, can dramatically affect the finance required. In effect, good credit control can be a source of finance.

This isn't a luxury all businesses have: someone at the end of the chain has to wait for payment to trickle down to them. Most often they are the small businesses, sole traders and businesses in the most competitive markets.

There are ethical issues here – it may be in your individual interest to delay paying bills as long as you can while insisting on immediate payment by customers, but this is clearly a double standard that is hard to justify. Nevertheless, some consideration of what can reasonably be asked of suppliers and customers should be part of your business planning. The appropriate use of credit control will depend very much on the business sector that you are operating in; there is certainly no harm in asking customers and suppliers early on what terms they would be prepared to consider.

4.1: Re-invested surplus

Obtaining capital by drawing on the profits earned from trade in previous years is (at first sight) the most attractive way for any organisation to finance its growth, because:

- it does not have to be repaid;
- no interest or dividend needs to be paid on the capital;
- there is no need to negotiate terms with any external investor.

However, there are limitations to this source of funds. It is of course only possible to raise capital to the extent of the surplus generated and not paid out to members and investors. If the enterprise gives the impression of giving poor returns to members and investors, it may find it hard to attract more.

There is also a danger that if large levels of unallocated reserves are built up, for example in a co-operative, it may tempt people to join the co-operative with the sole intention of demutualisation, or tempt existing members to discourage new members from joining. In other types of social enterprise, large reserves can make it a target for hostile takeovers.

Creditors are those to whom you have an obligation – you may have received goods from them but not yet paid, they may have lent money to you, or they may have paid for something that you have yet to deliver.

Debtors are those who owe money or an equivalent to you, for example because they have received goods from you but not yet paid. Debts arise as a result of an implicit or explicit contract.

A related issue is the possibility of reducing finance requirements by borrowing or leasing goods rather than buying them. This touches not only on questions of cash flow and interest costs, but also the tax implications. For this reason it is discussed in full in chapter 7.

Demutualisation happens when members of a mutual organisation vote to change its rules to gain individual access to its wealth. Only charities, community benefit societies and CICs have clear legal protection against this.

Reinvestment can reassure members that the decision not to allocate surpluses as dividends does still lead to real benefits for them. As the co-operative uses the funds to grow and improve its services, they should experience the benefits, and approve such retention in the future.

It is tempting to nominally allocate reserves, but actually refrain from making payments so that the liquid cash can still be used – for example, by crediting the members' share accounts. However, if reserves are allocated in such a way that a contractual liability is created then there may be tax implications – see 4.5.3.

Unallocated surpluses are profits that have been retained for reinvestment in an organisation, rather than being 'allocated' for the payment of dividends to members or shareholders.

4.2: Downpayments and advance purchases

Co-operative relationships can and should extend to the whole trading environment; the relationship with your customer in particular can and should be more than just a formal contract. A consumer co-operative – a village shop, perhaps, or a food co-operative – will already be aware of this and working with customers will already be an integral part of its planning.

There are issues of fairness in offering discounts to customers paying by standing order or in advance: customers who do not have the financial resources to pay in advance may be disadvantaged.

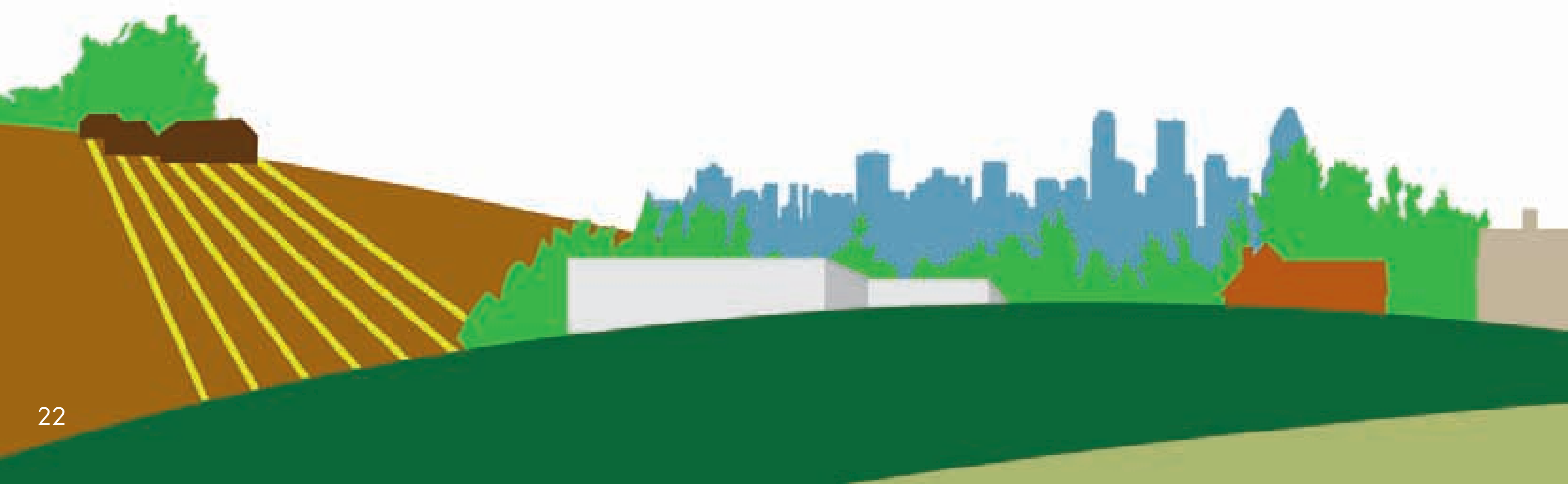
For a customer to pay in advance for a product may well be no big deal for them, especially if you sell many small items rather than a few large ones. It can even offer benefits, for example by allowing them to pay in regular, predictable instalments or avoid carrying so much cash. If you can make a case for advance payment, do: it could transform your finance requirements. If full payment isn't likely, consider whether this is a service that would suit a deposit, or downpayment; maybe there is a discount that can be offered for customers who pay early.

All this can be backed up with continual two-way communication – at the sales point, through a newsletter, through your website – that reminds customers of your ethos, identity and social returns. Customers like to be loyal, and to form long term allegiances with businesses that share their values; give them the opportunity to do so, and reward their trust with honesty and transparency.

4.3: Asking for credit

Knowing whether or not credit terms are likely to be available is a valuable piece of information that stems from knowing your marketplace; if you aren't immediately aware of whether this is commonplace, it should be a warning that you may be something of an innocent abroad, and you need to spend some time talking to people with longer experience of the sector.

Credit terms can be anything from the generous – three months or more – to the very tight (full payment on delivery). It is often tempting to go for the supplier that offers the best price, but it is wise to look for a supplier that might charge a little more but with more reasonable terms. That having been said, many businesses are understandably wary of new starts.



Many new businesses fail at an early stage, so suppliers are understandably nervous that bills will not be paid and the promised long term relationship will not materialise.

While your business is stable extended credit terms may offer limited benefit, but if your business is steadily growing, it will seem as though you are paying the bills of a smaller enterprise.

Suppliers can, if you cultivate a good relationship, be part of your wider community of supporters. It is very much in their interest to support potential customers and help them to expand their business.

Some of the terms that might be available are:

- discounts;
- access to seconds;
- end of line products;
- returned goods that would otherwise be of little value;
- goods provided for a trial period or on hire purchase.

If you can persuade the supplier that you can make use of their otherwise idle stock – and perhaps maintain its value by doing so – you could have the basis of a good reciprocal deal.

Case Study: Brighton Rock Housing Co-operative

This Co-operative was first established in 1997 as a short-life housing co-operative. 'Short life' means that it takes over properties where the owners are unable to make the improvements needed to obtain a commercial rent. The co-operative has a licence to occupy them for a fixed period of time, which can sometimes extend for many years. The owner of the three terraced houses used by the co-operative (Brighton and Hove City Council) benefits because the buildings are being looked after, and the co-operative has access to properties without the need for large scale finance.

The government itself offers some limited credit terms; some businesses, for example, will prepare VAT returns quarterly, which means that for a brief period of time you have charged your customers VAT without having had to immediately hand over the cash to the government. Small businesses can also pay VAT only on those sales that have been fully paid for ('cash accounting'). See also 8.1.2.

PAYE and NI payments are usually made monthly but these can also be paid quarterly by small businesses if the monthly PAYE/NI payments would be on average less than £1,500 per month.

Makers is a co-operative consortium of craftspeople in and around Taunton. It has a shop in the town where the goods produced by its members are on sale. Conventionally, a business of this sort would have to buy the stock before it could put it on display in the shop window. However, Makers' members provide the stock on a sale-or-return basis. A fine display is possible without having to be financed.

Ipswich Food Co-operative asks new members to pay a £12 joining fee. Dalnavert Community Co-operative purchased a 150 acre farm in 1983, and asked its members at the time to pay a £2000 joining fee. By contrast, the Co-operative Group (the largest co-operative in the UK) still asks for only £1.

Some argue that co-operators who escape the exploitation of ruthless employers only to impose worse pay on themselves have only achieved 'self-exploitation'. Recording unpaid or underpaid work as a form of investment in the organisation makes clear that is not the intention. It can also provide a record for observers of the organisation of the level of commitment made by its founders, which may encourage them to offer support.

Some of these relationships will be formal, others will be informal and relaxed. Informality is understandably preferred by many. But formal terms and written agreements have the great merit of avoiding ambiguity, and can be referred to later when memories have faded.

4.4: Membership fees

Membership organisations, whether they are made up of customers, workers, suppliers, service users or a mix of stakeholder groups, can raise some of their finance from a membership fee. This recognises the future benefit that they will gain from membership and the costs to the organisation of administering their membership.

Most organisations will ask for at least £1 on joining, but a larger minimum shareholding can be specified, or a fee that is a condition of membership (which allows the income to be recorded as income). In the latter case it can be a one-off fee, or a regular annual subscription.

Co-operatives should take care to ensure that the level of the fee is not so high that people who could otherwise benefit from the co-operative's services are excluded.

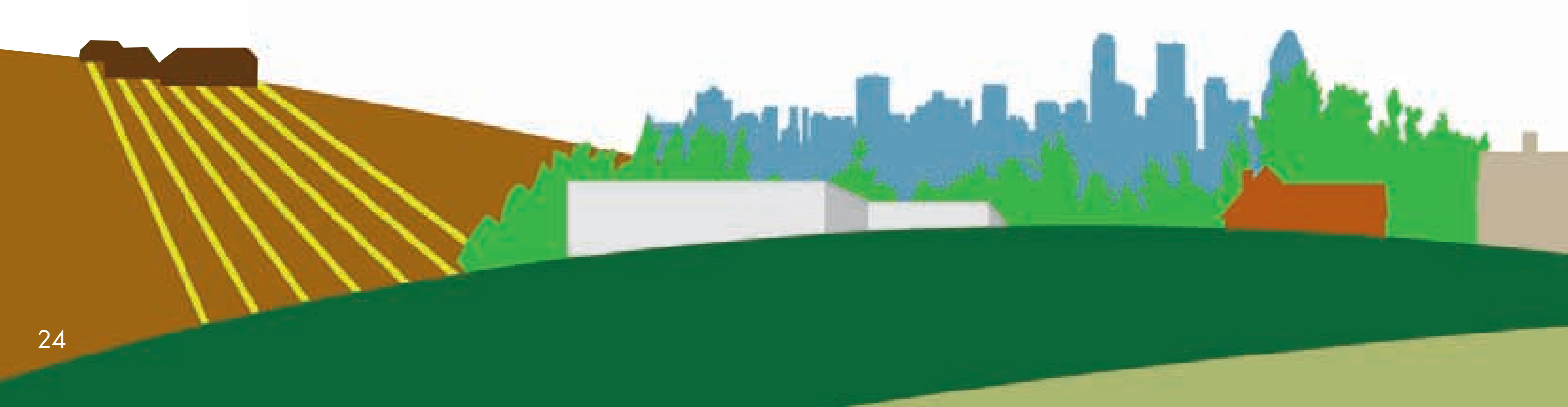
Higher annual subscriptions are most appropriate where members are expected to get a long term benefit from the organisation's services, and those services are only available to members.

4.5: Sweat equity

Sweat, or work, equity may be the most significant early source of finance for the businesses that are the household names of today. Put simply, they got started because the people who were working the hardest were not expecting to get paid much, or anything, until much later. It is common for small businesses to be run almost as a labour of love, and with hourly rates (if they are calculated at all) well below minimum wage.

Tensions between founder members (with memories of early struggle) and newer members (with expectations of a steady job) are not unknown; work equity provides an objective measure of the debt owed that makes negotiations less fraught. However, it is a complicated area, and needs considerable thought and preparation at the outset. Some of the issues to be addressed include:

- labour can be recorded as either a debt, or as a share of the organisation's equity. The pros and cons of each are discussed in 4.5.1 and 4.5.2, and the tax implications in 4.5.3;
- conventional businesses are often started by people who own them outright. If they add to the value of the business they have enriched themselves no less than if they were salaried. This is not the case for a socially owned business, and there is no direct connection between the number of hours put in and the eventual worth of the business. Instead, a realistic value must be negotiated;



- Many organisations seek to include and work with the poorest in society. They may well be unable to accept deferred payment. In these cases work equity may prove to be incompatible with the organisation's mission;
- co-operatives are often started by teams of workers, and it may be divisive to ask some of them to accept work equity but not others. A fair and voluntary arrangement should be negotiated;
- social enterprises hold assets in order to achieve their mission; common ownership co-operatives build up indivisible reserves for future members. There is likely to be a tension between the desire to reimburse founders on the one hand, and protect the assets of the organisation (and hence its mission) on the other. Payment of work equity could be triggered by the achievement of agreed targets.

4.5.1: Historic debts

Perhaps the simplest method is to record the hours that are worked unpaid, and agree a date by which they will be paid. Pay and conditions in the organisation may well improve over time: it would be wise to agree to what extent the value of those unpaid hours will increase in line with paid hours. The hours should be recorded in sufficient detail that in the future there will be no difficulty accepting that all the hours that were worked in the past were genuinely of value, and that the worker was in some way accountable for what they did. A payment of interest could be made to compensate the worker for not having had access to the funds.

These details need to be in a written agreement drawn up before the work begins. Instead of a regular schedule of payment, there might be a 'trigger' for the payment – for example 'when the co-operative makes a profit', or 'when the co-operative has a turnover greater than £30,000'.

An alternative is to not record hours of work, but instead look at the product of that work and place a value on it. It is difficult, however, if there is no obvious monetary value, or if several people have worked on one thing to varying degrees. In reaching an agreement on how labour should be valued, all parties should bear in mind that some degree of approximation is probably inevitable. A problem with these debt-based approaches is that as they accrue on the balance sheet they could make the organisation seem highly indebted; it may even make it hard to recruit new members when they see the debts that they will be paying off. Limits should be agreed early on to prevent the obligation becoming too onerous.

4.5.2: Shares for work

The very term 'sweat equity' suggests another way of managing this deferred payment; by issuing shares in the enterprise to the workers in lieu of cash.

In order for this approach to be followed, the enterprise will need to have a suitable legal structure that allows shares to be issued to employees (and in the case of co-operatives, converted if the holder ceases to be an employee). See chapter 6.2, which describes the different types of

You could use an amended loan agreement, such as the one in Appendix 4.

UpStart Services Limited formed as a workers' co-operative providing support and advice to other co-operatives. In its early years, it had few customers and limited income; staff were paid very poorly, if at all. However, detailed timesheets were kept from day one, that allowed the co-operative to track each year its unpaid labour. This did create a substantial liability on the accounts, but funders and lenders accepted that it was manageable because it would not be repaid until the co-operative could afford it. Five years after the co-operative was established, it refinanced with a loan and paid all the work equity at the more generous hourly rate that was then in effect.

Some consumer co-operatives introduced employee share ownership schemes that allocated shares on the basis of the number of hours worked. The 'free shares' were eligible for tax relief provided that they were retained for a minimum period of time. Others used a different approach; 'partnership shares' could be gained through a salary sacrifice, so that shares were issued in lieu of pay. Again, the tax reliefs made this an attractive option even though the shares were fixed at a value of £1.

share that could be used and the legal structures that can use them.

Care should be taken to reassure anyone that has invested in the organisation using shares that the work equity represents real value that the organisation would otherwise have had to pay for. They may otherwise be concerned that their stake in the organisation has been diluted.

4.5.3: Unpaid labour and taxation

You might think that if no cash has been handed over, no tax needs to be paid. That is not necessarily the case. It is in fact usual to include the value of shares with pay when calculating PAYE. However, there are some cases when this is not necessary.

The issue is whether payments are made in the form of a 'readily convertible asset'. What this means is if you are not paid in cash, but you are given something that you can turn into cash quickly, then tax and NI should be paid as if cash had been paid. If not, tax is payable at the point that it becomes readily convertible. Be warned that it is not always obvious what is and is not readily convertible.

Promises to pay after a period of time, or on fulfilment of certain conditions, are taxable only when the payment falls due. Transferable shares are not considered to be readily convertible unless they can be traded on a recognised exchange; and all shares can benefit from certain tax exemptions under an approved Employee Share Ownership scheme.

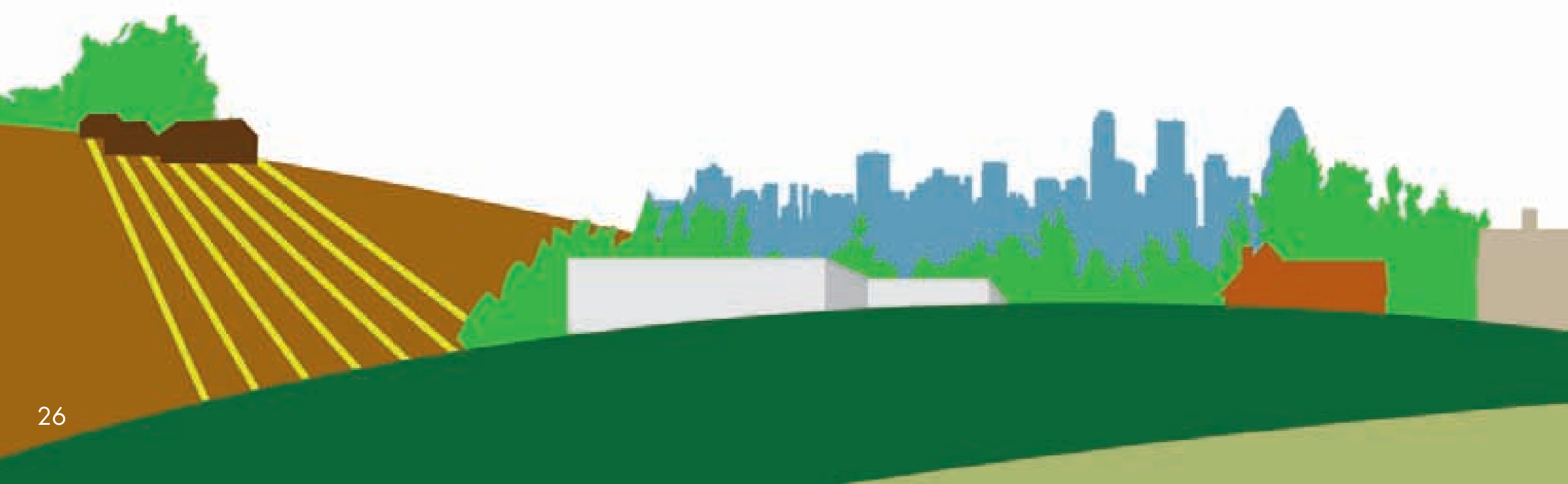
It may be that the payment of sweat equity does not relate to an employment relationship – for example, someone may have produced on asset for the organisation for sale in their own time, and not as an employee. That might mean that PAYE doesn't arise, but the earner should still declare it as self-employed income once they have received cash or any other readily convertible asset.

This is a complex area, and approval from your local tax office, or advice from an accountant should be sought at an early stage.

4.6: LETS, Time banks and alternative currencies

Many people around the country are now, or have been, members of a Local Exchange Trading System (LETS). Along with time banks (which are similar, but a bit more specialised to encourage volunteering) these innovative alternative trading systems have created local currencies to enable trading that might not otherwise take place.

The genius of LETS is that rather than being tied to scarce resources (such as central bank reserves) it is based on a promise by the community to provide an appropriate amount of labour on demand. That means that the currency can be brought into existence as required – the more trades that happen, the more currency is issued. It is not scarce, so no interest is charged, and no one ever has to wait for payment.



The downside, of course, is that not everyone is a member of LETS, and so the goods and services you can obtain are limited to a very local pool. Often they are not the things that a new organisation really needs to get started. However, there are some things that LETS quite commonly does well – hire of common tools and equipment, for example, work parties made up of local unskilled labour, or surplus veg from allotments.

If you can spot something useful, and you are willing to commit to being part of the trading community for the long term, you can use LETS as a kind of zero interest credit.

The taxation and accounting implications of LETS are notoriously unclear, and such definitive statements as have been made largely relate to income tax and benefits rather than company taxation; but we can say that if your LETS account achieves a positive balance as a result of selling the goods that you normally trade in partly or entirely for LETS credits, then this may well contribute towards taxable profits and you should discuss the matter with your local tax office.

4.7: The bottom line

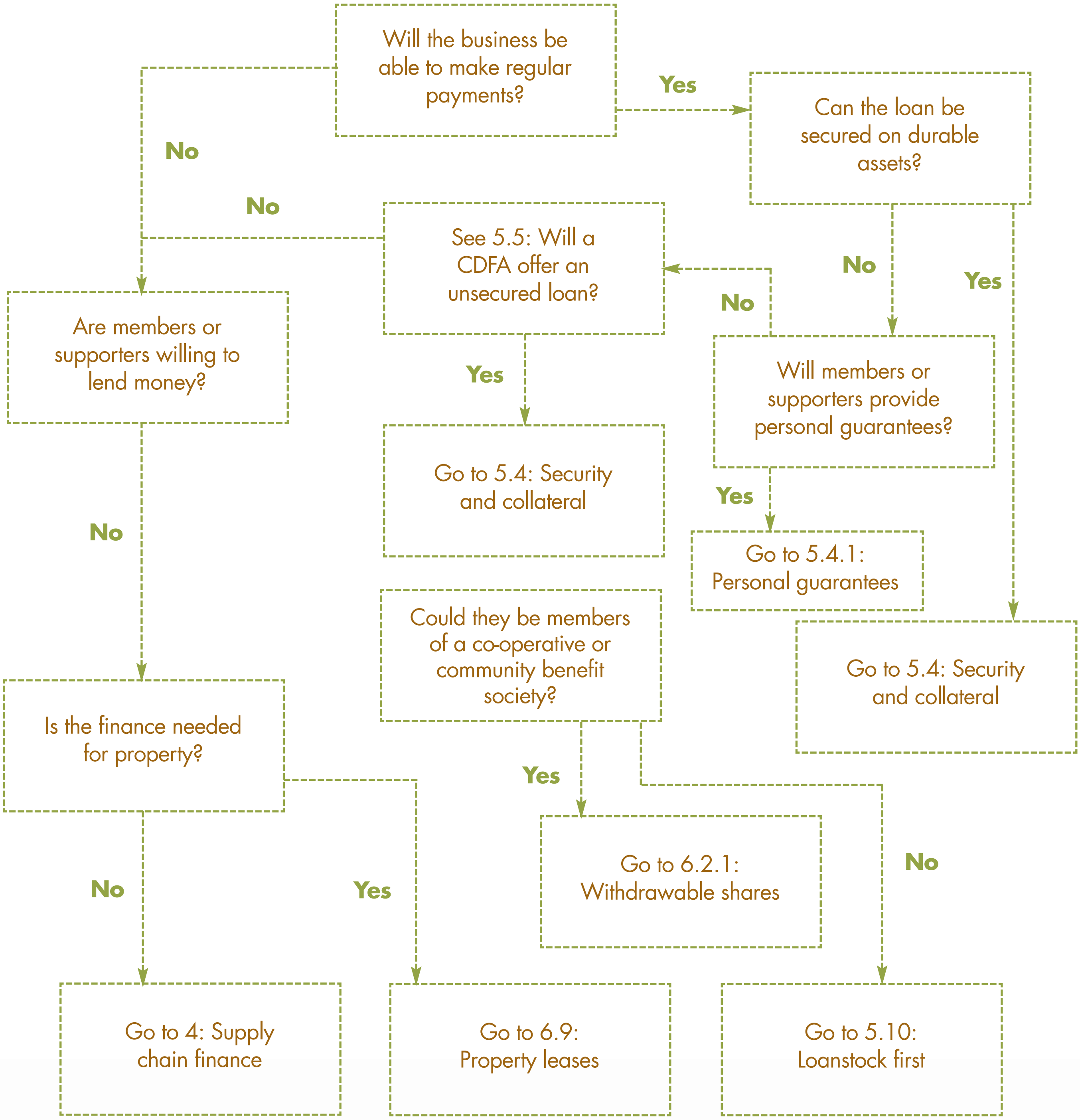
What effect will these have on the bottom line – the financial accounts that your co-operative prepares?

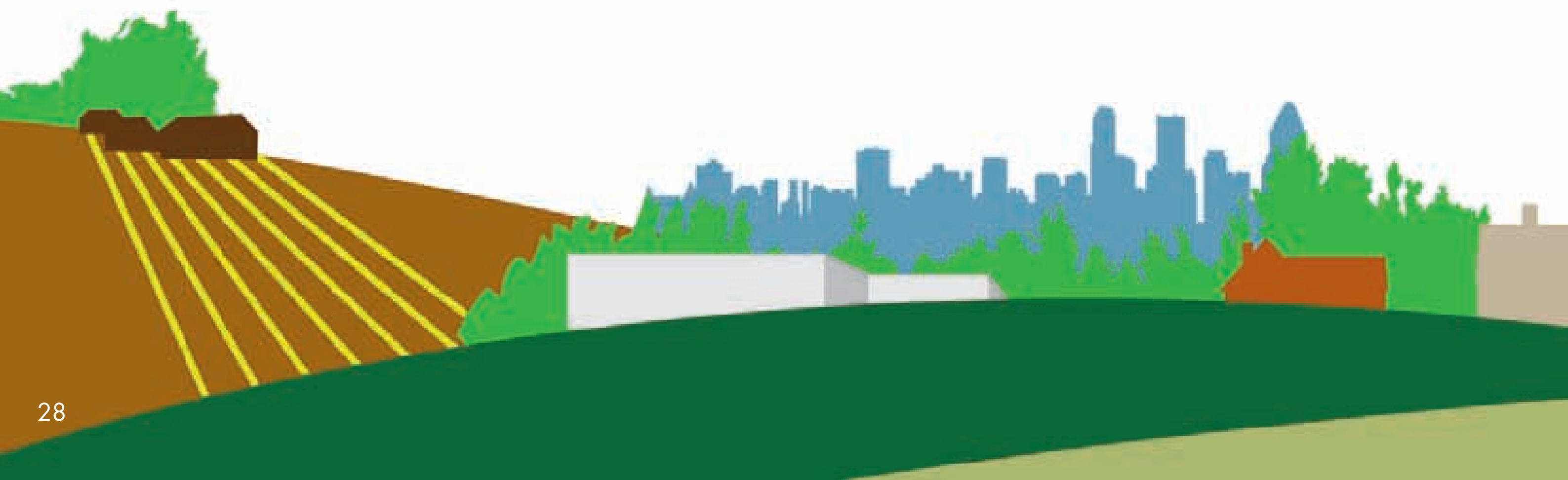
Advance payment by customers, late payment of suppliers and deferred wages are all promises to pay or deliver that must be kept: that means that for all the good they do for your cash flow, they will be very visible on your balance sheet as creditors - i.e. amounts owed to others by your organisation.

When you accept an advance payment for your services, you are obliged to give something of that value in return. You might make a profit on that sale; but until the trade is completed, that profit will not be visible in your accounts.

If you have undertaken to reimburse sweat equity only in the event of certain conditions being met (the ‘triggers’ discussed in 4.5.1) then the position is a bit more complex. You will have to make a judgement as to whether the condition is likely, or intended, to be met within the next year (a current liability); eventually but after more than a year (a long term liability); or not at all, in which case it need not appear. You will want to take advice from an accountant if you are at all uncertain.

Your route through Chapter Five





Loan finance

5

Loans come in all different shapes and sizes, for all sorts of different purposes. Typically, their features will include the following: a rate of interest, possibly varying but more commonly fixed; a schedule of repayments, at the end of which the loan and all interest accrued will have been repaid; and penalties on default, which may include the loss of any goods or assets that you have offered as security.

There are many different kinds of lenders, and the best will work with you to help your organisation succeed and be willing to consider alternative repayment schedules and refinancing if difficulties arise. Also, they will go through your business plan carefully to ensure that there is no great chance of default and that the loan will do good things for your organisation as well as for the lender itself.

This scrutiny can be frustratingly slow and some organisations may struggle to present their financial plan in an acceptable form. This can make borrowing from friends and supporters more tempting. However, meeting the requirements of a bank is a discipline that encourages careful planning, and can in itself improve your chances of success.

There are still a few that show an unhealthy, predatory interest in your collateral (the security that you forfeit in the event of a default) and less in your actual business plan. This type of lending may seem to meet an urgent need, but should be avoided nonetheless.

Borrowing money means that when the worth of the organisation is calculated, loans will all appear as creditors (liabilities), dragging down the value of the organisation and advertising to anyone looking at your accounts that a good chunk of your future earnings (or even your present assets) are spoken for. Borrowing is understandably sometimes resisted by members concerned about their obligations.

5.1: The benefits of debt

Nonetheless, there are many good things to be said for loans as a form of finance. They are regular and predictable. When they are paid off, they are gone for good and you are free to start contemplating the future with a blank slate. When there is a real win-win relationship, and both you and your lender can clearly see that you will both profit from the arrangement, the availability of the finance will be unproblematic compared to hunting down grants or investors.

An organisation that has borrowed £12,000 and has funds of its own (perhaps from share capital, or perhaps from accumulated profits) of £2,000 has a debt/equity ratio of 6:1, (600% - or you could say debt is 86% of capital employed). That would usually be considered very high.

For example, an organisation with an operating profit before interest and tax of £3000 a year, which is paying out £2,400 a year in interest would have interest cover of 3000/2400=1.25.

Where there is a competitive market for loans, you can be confident that you are paying no more for the finance than is necessary – lenders cannot make unlimited windfall profits at your expense. Loans can be provided by businesses that are ethically driven or mutually owned themselves.

Should you wish to acquire a durable asset such as land or buildings, you may well be able to spread the cost over decades, making something very expensive quite affordable. The productive power of a good piece of equipment is often large compared to the loan repayments over the years of its life. In short, loans can really open doors and enable you to work in the places and with the tools that you would really want.

5.2: Gearing – the measure of indebtedness

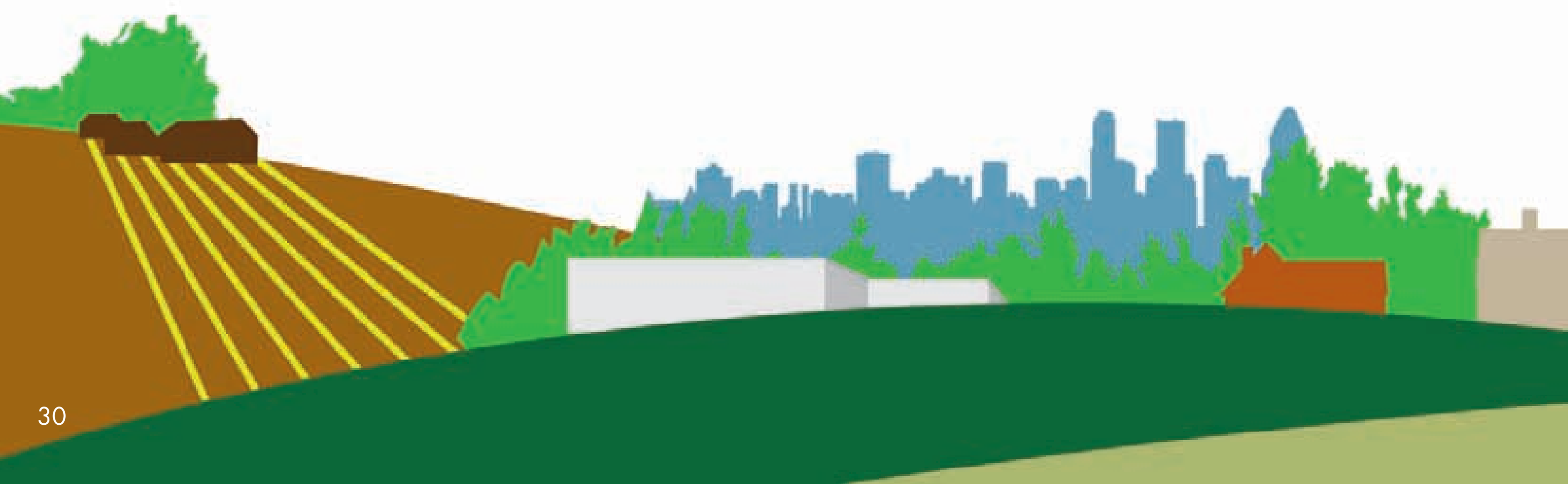
Businesses, like people, are careful not to borrow more than they can afford – but it can be hard to establish where the limits are. The issue is known as 'gearing' and the measure that is most commonly used is the ratio of debt to equity. A ratio of 1:1 or 100% (as much debt as equity) is not uncommon. A highly geared organisation is at risk because it has to make substantial payments of interest until the debt is repaid, with little or no breathing space.

A less common measure of gearing is interest cover, which measures the number of times that interest payments are 'covered' by profits before interest and tax. Less than two would indicate that a great deal of the profits from trading are doing nothing more than paying the interest on debts (less than one, of course, would mean that the organisation was actually making a loss). However, what constitutes a suitable gearing ratio is very different for different businesses – what is normal in one setting would be considered extreme in another. And it is possible that an organisation might not be borrowing enough.

If there are opportunities to grow a profitable business activity, and the organisation is confident that it will be able to cover repayments easily, adding debt finance will help it meet its social objectives and serve its community better. It would be a mistake to set gearing too low: debt is sometimes called 'leverage' because it magnifies the spending power of your organisation's own capital.

Some equity investors like to see judicious use of debt; if the enterprise is getting a return on capital higher than the anticipated interest rate, replacing some equity with debt will concentrate profits on a smaller number of investors. Pressure from investors to do this should be resisted if it would make the business unstable.

However, even if you don't issue shares a similar benefit can be seen in retained profits: assuming that there is plenty of scope for profitable activity, combining reinvested reserves with a loan allows you to build up those reserves faster.



There are some questions that can help with assessing an appropriate gearing ratio. Start with the assumption that the debt equity ratio should be around 2:1 – or better still, draw on examples from similar businesses in the same sector.

Social and co-operative enterprises do face very different issues. They may reasonably have higher gearing if:

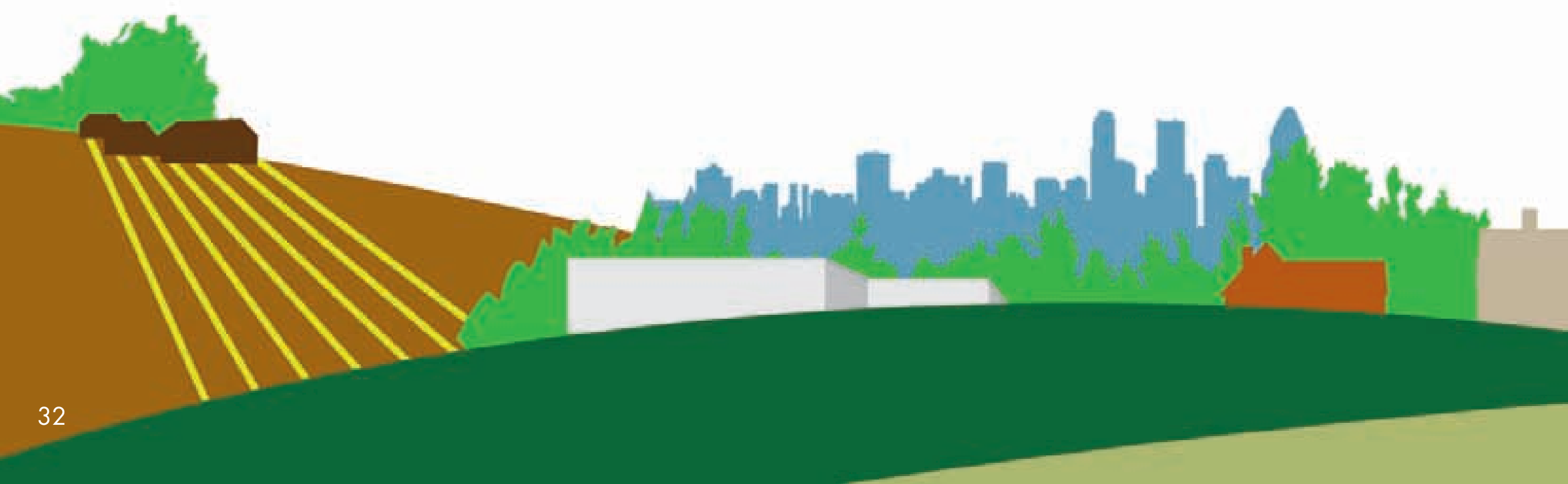
- some of their debt is in the form of equity-like securities such as loan stock (see 5.10);
- there is grant funding or supporter goodwill which, although it is not technically equity or reserves, can also be used to cushion the business against shocks;
- they are not seeking anything more than modest profits, and are taking correspondingly low risks;
- their business is largely about the management of property or other durable assets;
- inputs from volunteers make overheads and running costs unusually low.

5.3: Different forms of lending

Having thought it through, an organisation may be clear that loan finance would be a sensible and effective part of its finance package. There are a number of different types of loan that might be available:

- the mortgage: a loan secured on property, typically over a long repayment period of twenty years or more. Regarded as low risk, because of the durable nature of property, and so lower interest. Mortgages will normally only cover part of the purchase cost; this is governed by the loan-to-value ratio, which is typically around 70%;
- top up loans. Sometimes used to cover the gap between purchase price of a property and the mortgage, they are secured using a 'second charge' and/or personal guarantees. Typically medium interest rates and repayable over ten or fifteen years;
- loans for plant or equipment: may be closely tied to the particular item or provided by a company specialising in the supply or finance of these items. May be repaid over a little less than the life of the asset, for example five or seven years;
- loans for working capital: working capital refers to funds that can be spent in labour and services. Spending money in this way may build up skills and knowledge, goodwill, public profile and business relationships. These are all worthwhile, but it can be hard to accurately assess their value or use them as collateral. For this reason, such lending is regarded as more risky, and may have higher interest and shorter repayment periods of one to three years;
- overdrafts: a facility to borrow as required up to a limit, with payment of interest but no repayment schedule. Generally limited in size, flexible in application, but quite expensive with higher interest rates. They are usually repayable on demand, and should not be used for long periods.

	What is secured?	What happens on default?	What are the limits to liability?
Personal guarantee	The funds belonging to a third party, either individual or corporate.	The guarantor will be asked to pay the outstanding debts, shared fairly among all guarantors.	The guarantor will have set a maximum value of their guarantee – but see 5.4.1.
Legal charge, or fixed charge	Named, saleable items; usually plant and equipment, but can cover goodwill and intellectual property.	The lender can require that the named items are sold to pay debts, or take possession of them directly.	If the assets don't sell for their full value, the lender can force the sale of more of them until the debt is cleared.
Mortgage	Land or property.	The lender can repossess the house, taking the keys and selling or letting it to clear the debt.	If the property sells for more than the value of the debt, the surplus must be returned to the borrower.
Floating charge	Unspecified assets of the organisation.	The lender can require that assets are sold, and can even seize them if necessary.	Assets will be sold until enough funds have been raised to repay outstanding debts.
Unsecured	Nothing, other than the organisation's funds.	Funds can be sought through the courts.	The business can be forced into liquidation if it is unable to pay.



5.4: Security and collateral

Different types of security carry very different penalties in the event that the borrower defaults, or fails to comply with the loan agreement. It is important that the security used is appropriate for the organisation.

5.4.1: Personal guarantees

Personal guarantees can be a useful way of turning the community of support that many social enterprises and co-operatives enjoy into increasing confidence for lenders. However, they can also defeat the purpose of the organisation by asking individuals who can't share in the profits to nonetheless take a share of the risks. Furthermore, the all-or-nothing nature of the support really makes them only suitable for people with substantial wealth to fall back on – not something that the stakeholders of most community enterprises can count on.

Where more than one person signs a guarantee, it will be expressed as a 'joint and several' guarantee. This means that the bank can demand that each guarantor pay the full outstanding amount of the loan or any lesser sum at the bank's discretion. Though there is a presumption that the people signing it will have equal responsibility, if for whatever reason some of them default, an unexpectedly high burden can fall on the remainder. Joint and several guarantees are unusual in the social and community enterprise sector these days, and individual guarantees are preferred.

However, since some guarantors may fail to pay up, the total value of the individual guarantees may exceed 120% of the sum borrowed. Guarantors are usually expected to provide evidence that they have the liquid funds readily available without excessive hardship, and sometimes are even asked to place some of the funds on deposit with the bank.

Typically the lender (or hirer – guarantees are sometimes used for leasing, and referred to as 'surety') will provide a legal agreement to be signed, and the terms should be closely checked. When are guarantors released? Is it possible to provide replacement guarantors in order to release those who no longer have any contact with the organisation, or replace guarantees with fixed charges later? Can the same guarantee be used for additional borrowing in the future, or will it expire at the end of the loan term? How much time is allowed for the guarantee to be paid after the 'trigger event' that makes you liable?

Guarantors can be rewarded with a modest payment of annual interest on the liability to which they are exposed; in that case, a separate agreement will be needed between the guarantor and the borrower. More commonly however, their involvement with the enterprise is held to be reward enough. The borrower should

not leave the management of guarantees to the lender: they are best placed to ensure that contact details are up to date, and all guarantors ready at any time to honour their obligation, so that the burden is spread as evenly as possible.

5.5: Lenders with a social purpose

When we think of lending, we think of banks. The big names on the High Street do indeed have well developed systems for lending to businesses, and there is no reason why social enterprises and co-operatives should not approach them. However, local branch managers are often unfamiliar with the legal structures and can struggle to accept that social ownership makes some forms of security difficult or impossible. They also may not see the value of social aims in making the business case more robust.

A different attitude is found among community development finance initiatives (CDFIs). They are specialists in lending for the benefit of the community, and are very comfortable with trading for a social purpose, and familiar with the legal structures employed by co-operatives. They are diverse and often limited in their scope, but do include some large banks with a nationwide remit. Triodos Bank is in fact international, with its roots in Holland, and lends to a wide range of projects including organic farming businesses, housing co-operatives and renewable energy projects. Charity Bank was set up to provide finance to the charitable and voluntary sector, but has lent to a wider range of enterprises than its name might suggest.

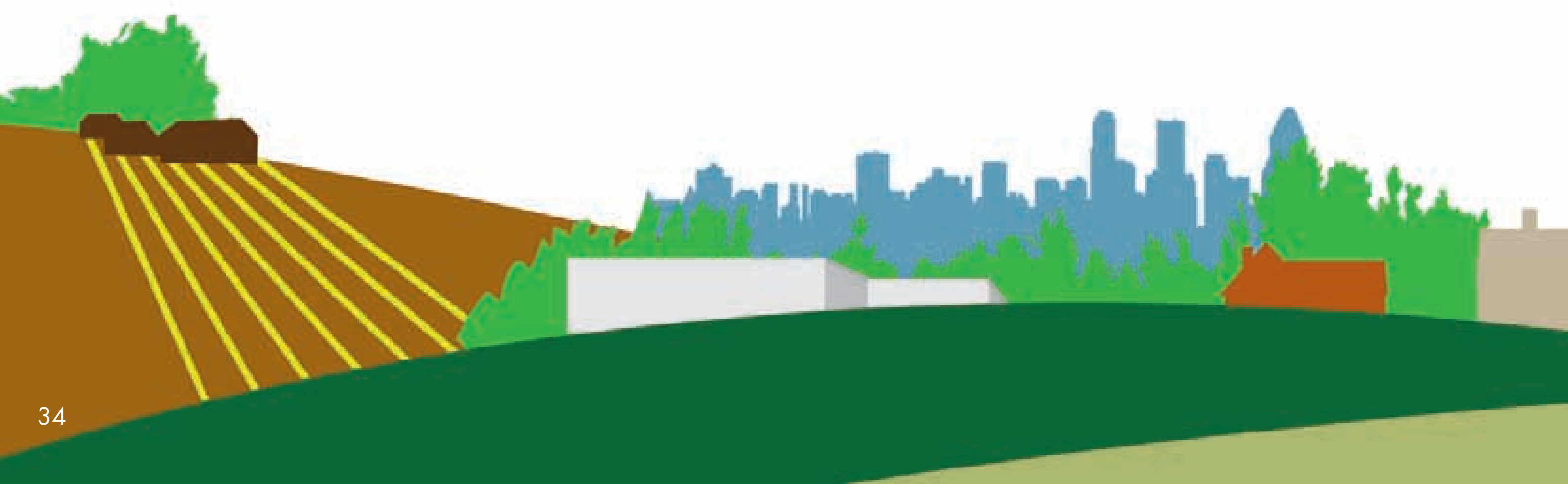
Co-operative and Community Finance (CCF) was set up to provide finance for co-operatives, and has proved very successful in raising investment for this purpose. They make small (up to £50,000) loans to co-operatives and community enterprises from a number of different funds. Unlike some banks, they do not favour the use of personal guarantees, seeing them as favouring people from a privileged background; so they make much more use of floating legal charges. CCF also manage funds on behalf of other organisations such as the Co-operative Fund.

Many CDFIs are locally based (like Wessex Reinvestment Trust, or Aston Reinvestment Trust) or specialists (like Radical Routes); go to **www.cdfa.co.uk** for further details of CDFI's operating in your area.

Building Societies are also potential lenders to social enterprises, most of all when the loan is for the purchase of land or property. Smaller, local building societies that are in touch with their mutual heritage may be the most supportive, and there are one or two specialists – the Ecology Building Society has established a great reputation for supporting eco-construction projects.

5.6: What needs to be in place before applying for a loan

The value of a business plan was noted in chapter 2, but when applying for a loan it is absolutely essential. A responsible lender will regard security as necessary, but not sufficient. They will be more concerned with whether there



Case Study: Unicorn Grocery

Unicorn Grocery is a worker co-operative based in Manchester that's been in business since 1996. The co-operative manages a store that sells local, organic, fairly-traded and wholesome food products. The store also offers a selection of environmentally friendly baby products, cosmetics and household goods made from natural ingredients.

Since it was established, Unicorn Grocery has grown considerably in size. Its membership has expanded to over 50, and its annual turnover has increased from £3,500 to around £3.5million. As well as paying a flat-rate to its staff, the co-operative also donates around 5% of wage costs to local and international projects that relate to its clearly defined ethics and principles. These include:

- secure employment – the co-operative is committed to providing secure employment for its members that enables them to collectively control the business;
- equal opportunity – Unicorn Grocery reserves some of its employment opportunities for people with learning disabilities;
- wholesome healthy consumption – the co-operative is dedicated to trading foodstuffs that have undergone minimal processing;
- fair and sustainable trade – the co-operative trades preferentially in products that follow a fair trade ethos. It also seeks to educate its customers about the benefit of fair trade, and wherever possible it lobbies for the use of reusable packaging;
- solidarity in co-operation – Unicorn Grocery aims to support other ventures, including social and community enterprises, with similar ethics. It donates 1% of its wage costs to a fund to provide this support;

In 2005 the owner of the co-operative's rented store wished to sell the property. To avoid losing its premises and ensure its long-term sustainability, the co-operative raised the finance required to purchase the property itself. This was achieved through £350,000 raised from loan stock bonds bought by customers and loans provided by The Co-operative Loan Fund in partnership with Co-operative & Community Finance.

More recently Unicorn Grocery has remodelled the roof of its premises to create a natural environment featuring small low moisture plants, wetland, and brownfield that will create a variety of habitats and improve the building's insulation. The co-operative hopes that the roof will also become home to the Black Redstart – a rare breed of bird that only breeds in cities.

is a business plan that proves beyond reasonable doubt that the business will be able to service the loan without difficulty.

All lenders will question the details in the business plan before deciding whether to make a loan. Some of the danger signs that they will be alert to include:

- is demand for these products vulnerable to changes in market conditions?
- are sales forecasts speculative, or based on hypothetical customers, rather than being based on confirmed orders?
- are other businesses like this generally geared rather lower?
- is depreciation fully accounted for and realistic?
- is the business dependent on occasional large sales?
- would additional investment be soaked up by the organisational costs of growth, or by high overheads?
- are returns on investment low?
- is there a lack of trading history, or is there a new, untried product?
- is the profit margin quite narrow, with costs of production accounting for most of the sale price?
- are suppliers unspecified, and costs based on estimation rather than quotes?
- are there necessary permissions or licences that are yet to be secured?
- are key personnel yet to be recruited, or is project management neglected?

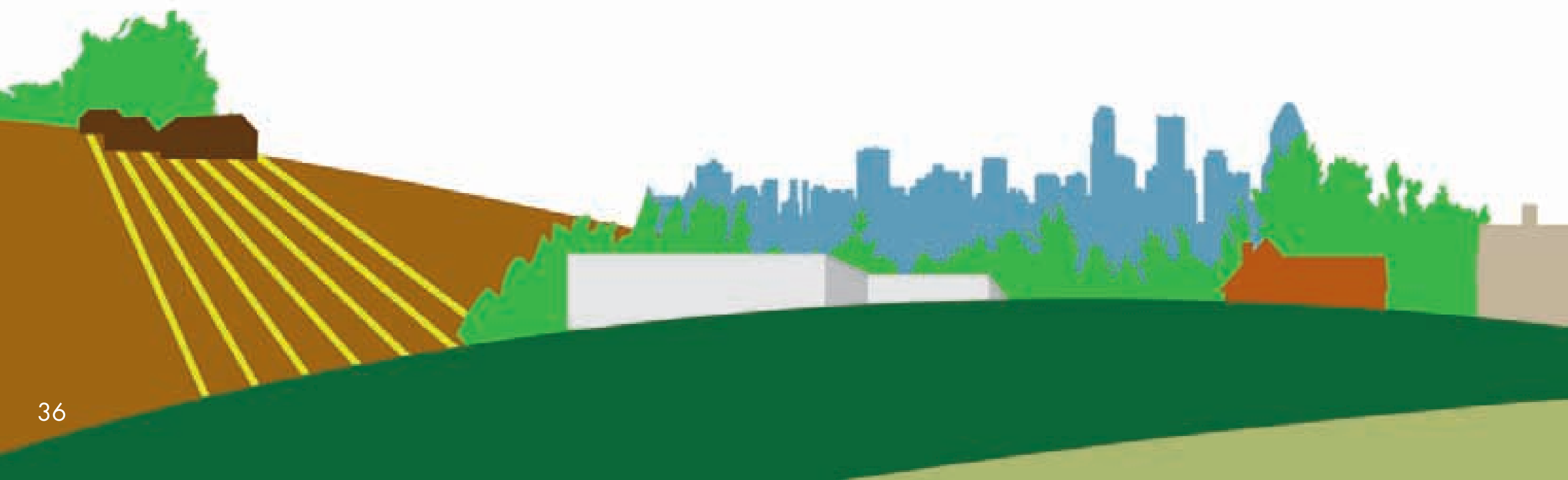
Banks, for the most part, do not see it as their business to take risks. The business plan should all but eliminate the element of chance to find favour. That having been said, a good lender will also be prepared to put some time into working with the borrower and helping them to make improvements to the plan and resolve areas of uncertainty.

You will also need to provide details of your legal structure, and it is important to make sure that any unresolved issues with the governing document or other organisational matters are concluded before seeking loan finance.

5.7: How will it change your organisation?

An organisation with a loan is, in some ways, different to one without: it should have a life of its own, not depending on one person to drive it forward. Repayment schedules over several years mean that it should have a regular, steady level of activity, not working in fits and starts or prone to strong seasonal fluctuations. It is not optional to be busy when its members feel like it and dormant the rest of the time, a continual obligation is needed. This is, however, what all businesses should aspire to, because otherwise they are liable to be just a flash in the pan and of no lasting consequence.

The relationship with the lender will be one of the most important relationships you have, beyond your staff and members. They may well ask for higher levels of monitoring and reporting than you are



used to, but this can be the trigger to make that same information available to your governing body, members and stakeholders. That in turn can make your organisation more intelligent in its planning and its ability to anticipate problems.

5.8: Qualification loans

A qualification loan is another way in which members of the organisation can be asked to provide start-up finance for the organisation. It is a simple loan, typically carrying little or no interest, with some features more commonly associated with equity. For example, a qualification loan may not have a fixed repayment schedule, but instead may give considerable discretion to the governing body to determine when and how they are repaid.

In co-operatives, the third co-operative principle of equitable contribution of capital should apply. All members should be under an equitable obligation to make a qualification loan, but the size of the loan may vary depending on the size of the members' transactions with the co-operative. So each year, the scale of a member's involvement will be reassessed, and it may lead to the loan being reduced, and a repayment made, or the loan being increased.

A qualification loan will normally appear as a long term creditor – though depending on the conditions of the loan, it may move into current (short term) liabilities if there is an expectation that it will need to be repaid in less than a year. When a member leaves it is normally hoped that their loan will be repaid, and that this will be financed either by the qualification loan from an incoming new member, or the increased reserves of the organisation, or the reduced costs of being a smaller organisation. However, it may be prudent to retain the power for the governing body to delay repayment until the organisation is comfortably able to afford it.

5.9: Loans from supporters

Of course, other supporters as well as members and banks can make loans, and they can be made with a wide variety of terms and conditions. Although it is possible to make such loans secured, it should only be considered where one person is the main lender for the organisation and they are highly trusted. If a bank would not make the loan, it is likely to be because they were not persuaded that repayments would be maintained, and so such security would be at some risk. Legal charges are powerful tools, and it is safer to leave them with reputable and professional organisations that will not use them arbitrarily.

Simple model loan agreement (with no security) – see Appendix 4.

Bonds are similar to loan stock – in fact, the two terms are sometimes used interchangeably – but 'bond' is often used to refer to more complex arrangements, for example debt securities that can be converted into equity shares.

A rate of interest should be set with reference to typical rates in the financial marketplace. A social enterprise or co-operative should not agree to rates of interest greater than would normally be necessary to secure the finance; it would in effect mean that the assets of the organisation were being used for private benefit. The governing document of the borrower may set limits on interest payments. The term of the loan should be shorter than it might otherwise be, as the circumstances of an individual can change a lot faster than those of a bank.

Supporters can be offered a choice of interest rates, from 0% up to the equivalent of a market rate. Many social enterprises find that supporters will choose 0% or a low interest rate because they want to support the social aims of the organisation.

A written loan agreement is essential, even if you are borrowing from a friend. Always remember that two copies of the agreement should be signed, so that each party has one to refer to. Some organisations go beyond their immediate circle of supporters to invite lending from the public. You should be very cautious in the way this is advertised. See chapter 6.6.2 for further details.

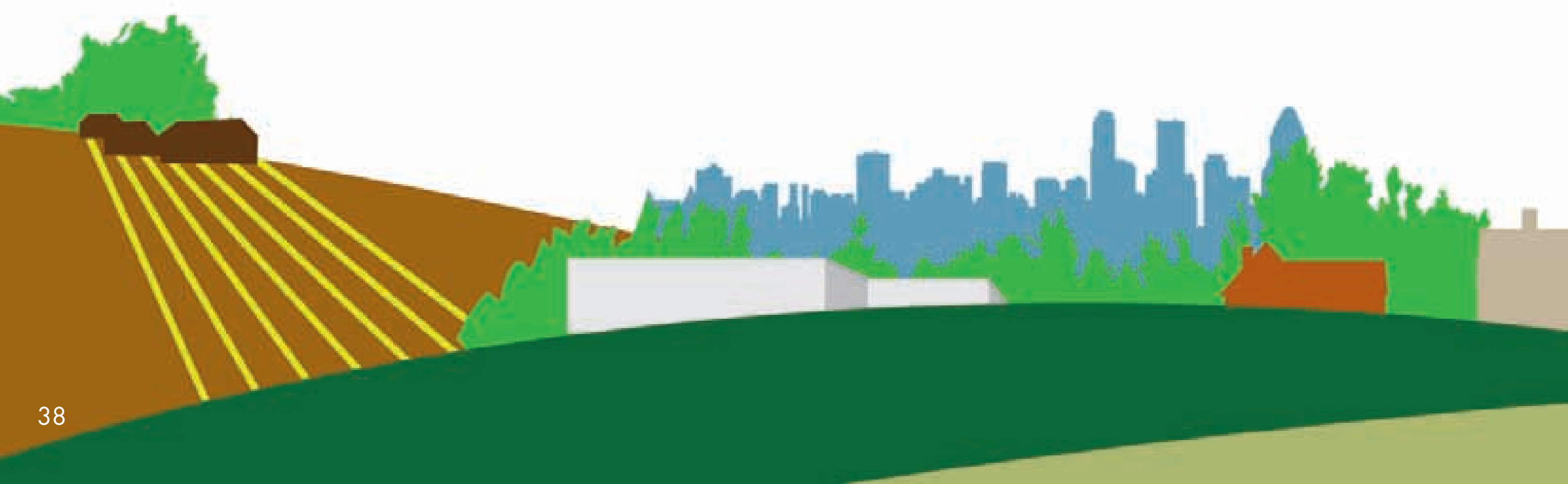
5.10: Loan stock and bonds

Loan stock is something of an anomaly in the world of lending: it is a form of debt, for sure, but it has many of the features of a risk investment. Typically, it comes not from banks and professional lenders but from friends and supporters (possibly businesses, but more often individuals). It usually has no schedule for making regular repayments – just a date on which the loan stock 'matures' and must be repaid in full. It is unsecured and so embraces an element of risk.

Because of the potential risks, it is preferable to spread the loan among a number of people – it needn't be the same amount lent by each person, but that is quite common because it is obviously seen to be fair. The investment is placed with the organisation for a fixed period of time; it may carry interest and (subject to certain conditions) it may be withdrawn earlier than the closing date. The lender/investor does not get any decision making power in the organisation.

It is quite a good idea to 'stagger' the dates of maturity so they don't all fall at once - this will also allow you to offer different terms to different lenders. Many schemes state that repayments can be made early, and may suggest appropriate 'periods of notice' for different amounts. However, the conditions should always make clear that such early repayments may be suspended at any time if the governing body of the organisation feels it would be imprudent.

Loan stock is ideal for a highly targeted ethical investment because it does not require legal advice to issue, and so is available to smaller organisations (though large or unusual issues should carefully



assess whether legal support might be necessary). There is no danger of the investors having control over the project, and the stability of the investment can provide a great deal of support, especially to a new enterprise.

Loan stock is repayable in full when it matures, which means that the issuer does not need to budget for regular repayments before the activity being financed has begun to generate profits. It is also unsecured, and this all adds up to a package which is more attractive to the borrower than the investors. For this reason, it is usually most appropriate to approach members, friends, relatives, committed supporters and others with a very strong interest in the project.

At the same time, it does offer some benefits to the investor - a high level of accountability (since you know exactly where your money is invested and what it is being used for), interest to prevent your investment losing value, and a close personal connection with the project.

It is used mostly by Co-operative and Community Benefit Societies (for example, housing co-operatives) who are exempt from the strictest legislation on soliciting investment. Companies registered at Companies House should not, in general, advertise loan stock schemes to the public without legal advice. More details about the legal promotion of loan stock and other 'securities' is provided in chapter 6.6.2. Each 'issue' of loan stock should have:

- a maximum amount that can be issued;
- a clear date of maturity (sometimes referred to as the 'closing date');
- a rate of interest (or a clear statement that no interest is payable). This rate of interest could be whatever is necessary to raise the investment and whatever you feel is possible within your business plan. It could be paid in the form of further loan stock, if that is clear in the conditions of the issue, with the same closing date. Potential investors can be offered a range of interest rates to choose from (including zero interest). If there is strong support for your social aims, investors are likely to choose the lower rates.

Some organisations have linked interest to inflation or base rates, but this is complex and risky. You can allow yourselves to vary the rates each year, but whatever you decide spell it out in detail in the conditions. If interest is set too low, lenders may find it unattractive; if it is too high, you may find it an expensive form of finance. It should always be clear to investors that it carries no voting rights. Make sure that when the investment is made, payments are made to the organisation and not to individuals – when handling other people's money like this there must be no possibility of fraud. The purchase of loan stock can look like 'deposit taking', which is a regulated activity (see 6.6.2). In order to avoid breaking the law, you need to ensure that you do not make repeated issues of loan stock with similar conditions. If in any doubt, take legal advice.

A simple unsecured debenture is provided in Appendix 4 – for more complex debentures, seek legal advice.

5.11: Debentures

Another example of a form of loan that behaves a little like equity is a debenture. In some ways it is similar to the loan stock described in chapter 5.10 – in fact the term 'debenture' actually refers to the signed agreement, and the finance itself might well be referred to as loan stock or a debt security. It is a long term debt, bearing interest at a fixed rate, but unlike loan stock:

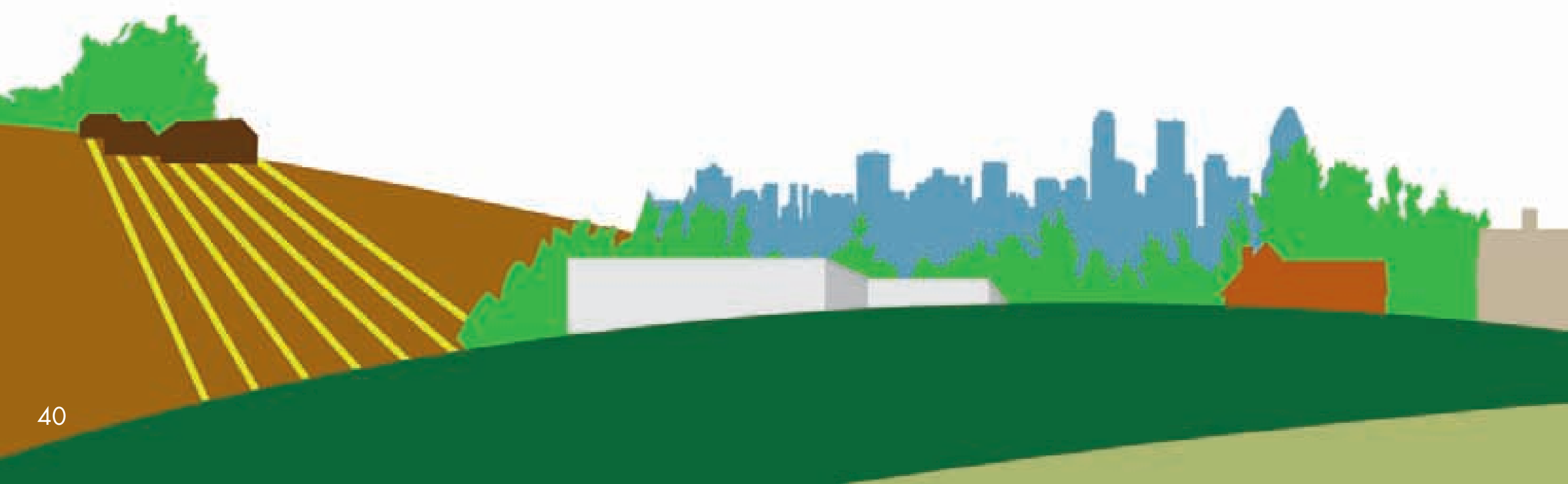
- it can be transferable, allowing it to be sold to another person;
- it is usually secured with either a fixed charge on a specific asset or a floating charge;
- it has no closing date, but instead is repayable on dissolution of the issuing organisation, or if the asset it is secured on is disposed of;
- interest may be fixed (usually when it is linked to a specific asset) or dependent on the success of the business;
- debenture holders can organise themselves to influence the organisation (for example approving rescue packages), without having a vote as shareholders would normally do;
- the debenture is subordinate to other creditors, so debenture holders are taking a greater risk. However, debenture holders will still be paid before any shareholders.

Because debentures are more complex than loan stock, but depend no less on trust, they are generally used by larger, well-established businesses. The fact that they are so similar to equity investment in the level of risk, and the manner of delivering returns, makes them extremely useful for companies limited by guarantee that cannot issue shares. However, as they are 'financial securities' the restrictions around marketing and promoting these schemes are no less onerous (particularly if the debenture is transferable); see 6.6.2 for further details.

5.12: Personal liabilities as a result of borrowing

Limited liability is one of the main features of incorporation. Many take it to mean that debt (the most common liability that you might want to be protected from) cannot become a personal responsibility.

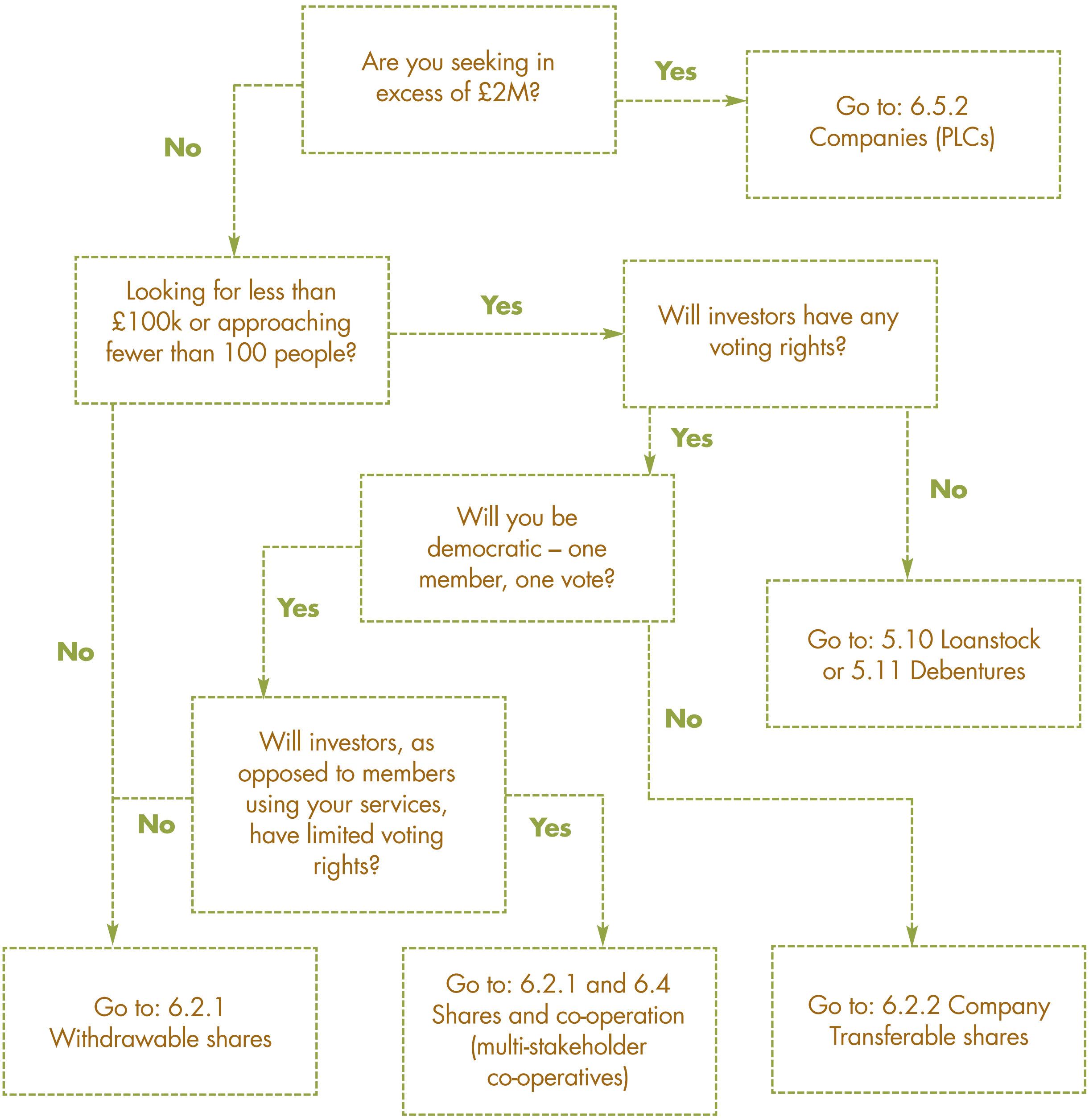
Up to a point, this is true. Provided you behave honestly and don't sign any agreement to the contrary, you will not normally be liable for the debts taken on by your organisation. However, there are exceptions. In the following situations a director may be held liable, not only to the organisation but to a third party such as a lender:

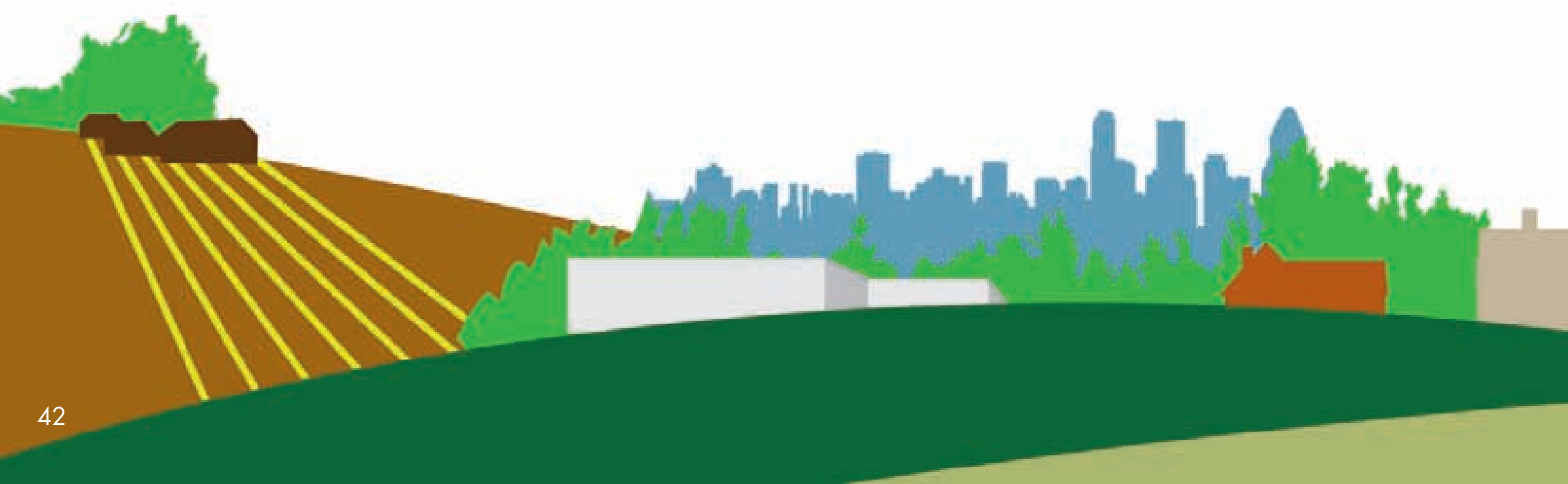


- illegal or ultra vires acts. If a director does something that is illegal, such as accept stolen goods and then resell them, they could be personally liable to repay the organisation if it is required to repay the true owner. An ultra vires act is one where the organisation does something which is outside its powers or outside its objects. This is unusual, as most governing documents include a general enabling power; it is only likely to arise in the context of charities;
- fraudulent trading. If the organisation continues to trade when one or more of the directors know it cannot pay its debts as and when they fall due it is very likely to be trading fraudulently. If it is then put into liquidation, the Court can make an order for directors to become personally liable for the debts of the organisation. In these circumstances they can be debarred from being a director for several years;
- acting without authority. If a director, for example, were to enter into a loan when in fact the organisation's governing body had not agreed to doing so or delegated the authority, the director could become personally liable. This is equally the case if they gave the impression that the loan was to them personally while they expected the organisation to service it in practice;
- party to a fraud. If the claims made to a lender at the time a loan is made are false (whether because of negligence, deceit or ignorance), the individual directors making those claims are liable.

Remember, most lenders don't like risk – if they did, you would be more likely to read about them in chapter 6 – so they only let go of their money when they are satisfied that steps have been taken to protect them.

Your route through Chapter Six





Equity finance and share issues

6

Equity comes from the Latin word for fairness, but in the field of finance has come to mean one's fair share of a joint enterprise. It covers the various ways in which a 'share' of an organisation can be allocated to an individual. These shares can be of many different types – they can be transferable (typical of private, profit-making business) or withdrawable, and they can be fully at risk or have their value protected in some way.

In general, having partial ownership of a business means that to some degree at least the value of your holding depends on the worth of the organisation and the proportion of the issued shares that you hold, and continues to do so indefinitely.

The term is not well understood by many people; others may understand it, but not like the implication that the business is controlled by profit motivated owners. It is often assumed to mean that an organisation's founders can sell it to investors, who can sell it on again. If the business has become more valuable between sales, this will be reflected in increased share values, and the seller makes a profit. This is, however, not always the case, and organisations more focussed on meeting a social need will want to avoid such speculation.

6.1: Distinctions between loans and equity finance

There are a number of forms of lending, such as loan stock, bonds and debentures, that mimic some of the features of equity. However, there are many reasons why they may still not be adequate:

- because bonds and loan stock grant no rights of participation in the organisation, they do not build a sense of community and membership. This can be very important to community enterprises and co-operatives;
- because debt must be shown as a liability, it can appear that no-one is willing to risk their funds on the organisation, which makes it seem vulnerable;
- because most loan stock and bonds have a date of maturity, periodic re-capitalisation is necessary, which creates unwanted pressure.

Equity, in the form of shares, is a secure, durable underpinning to an organisation, provided it does not inadvertently place the wrong people in charge of decision making or encourage speculative, greedy behaviour.

Companies have on occasion issued 'redeemable shares' which are similar, but this is very unusual and debentures are usually preferred for this purpose.

Some societies' rules allow for withdrawable shares to be reduced in value if the business suffers losses; they may recover this value, but never exceed the sum for which they were issued.

'Ordinary share capital' usually means those shares that are most at risk if the organisation loses money; holders of ordinary shares are the last ones with a claim on the assets after all other creditors and investors.

Liquidity means the ability to turn shares into cash; a liquid asset is one that can be sold or redeemed quickly and easily.

6.2: Different types of shares

The rights associated with a share are determined by the rules of the issuing organisation, and any conditions or agreements entered into by the buyer and seller. Though they are very flexible, there are some typical forms that they take. One organisation can issue more than one type of share – they are known as different 'classes' of share.

6.2.1: Withdrawable shares

Withdrawable shares are largely linked to Co-operative and Community Benefit Societies (formerly known as Industrial and Provident Societies). They can normally be withdrawn on request at the same value that they were bought (traditionally £1). If the organisation is wound up, the shares are worth no more than what was paid for them. They benefit from exemptions to the rules regulating share issues, which make them much easier to use (see 6.6.2 below).

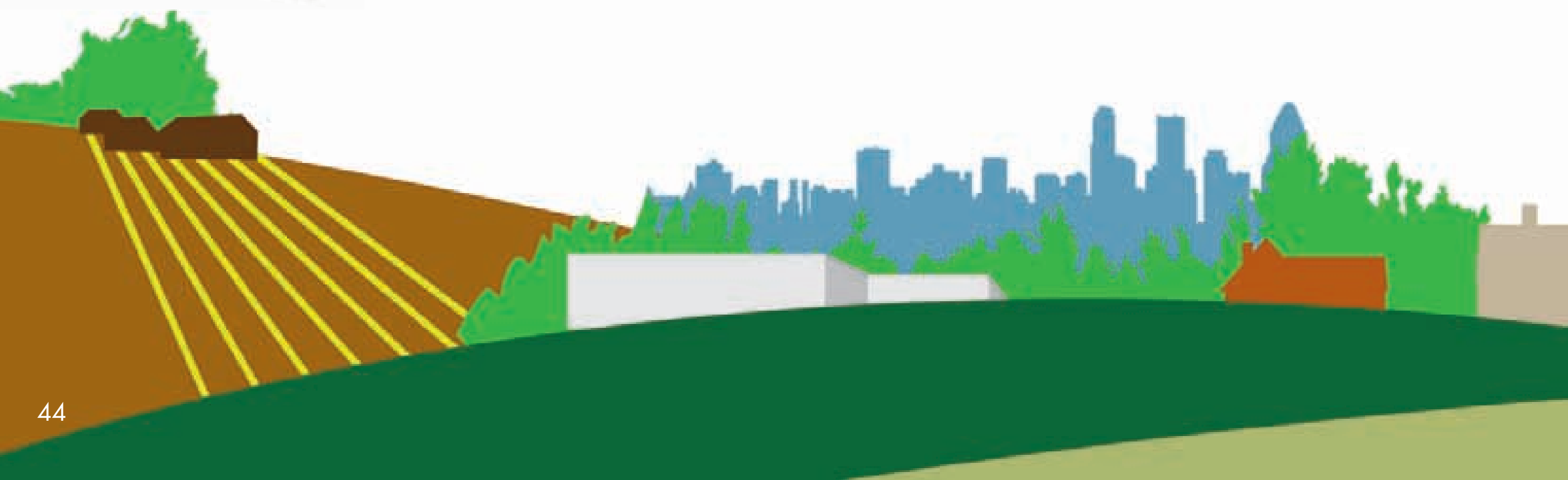
They are, however, full risk shares, appearing 'below the line' on the balance sheet (see chapter 7 for more details on these accounting conventions). Withdrawable shares are not protected by the Financial Services Compensation Scheme and investors do not have access to the Financial Ombudsman Scheme for matters relating to those shares. Although they are withdrawable, there is usually a period of notice required and withdrawals can be suspended altogether if the governing body believes it is necessary to maintain capital stocks; there is no absolute right to withdraw. As there is no need to find a buyer for shares, withdrawable shares are easier for non-expert investors in smaller organisations.

Withdrawals must be processed impartially, in the order that they would be due. The organisation cannot prioritise one person's withdrawal over another. With the only route of exit for investors being one that would reduce the capitalisation of the organisation, thought needs to be given to maintaining liquidity. There are broadly speaking two options:

- 'investor churn' means that new shareholders are joining as fast or faster than old ones are leaving;
- 'reserves replacement' means that accumulated profits are building up the society's reserves faster than share capital is declining.

6.2.2: Transferable shares

Transferable shares can be sold to any company or individual, and so can increase or decrease in value. There is no certainty over what that change will be, or indeed whether any buyer can be found. This uncertainty and potential for individual windfalls has made them less popular in the social and community enterprise sector.



There are normally two ways that the buyer can value a transferable share: i) what the track record of dividend payments is like, and what dividends are anticipated in the future; ii) what share of the assets of the organisation holders of transferable shares can call on if it is dissolved. In a social enterprise, a buyer may also attribute value to the social aims of the enterprise.

To avoid speculation and hostile takeover, the possible increase in value should not come principally from access to the assets, but only from the history and expectation of dividend payments. This can be ensured by putting appropriate conditions on the shares, such as:

- a ban on investors voting on resolutions for the dissolution of the organisation;
- dissolution clauses that require some or all residual assets to be transferred to a charitable or asset-locked body;
- an asset lock such as those applied to CICs and Community Benefit Societies.

Transferable shares in Co-operative and Community Benefit Societies carry identical voting rights to withdrawable shares – one member, one vote. That is not necessarily the case in companies.

6.2.3: Preference shares

Just as some forms of debt can behave a little like equity, some forms of equity can behave a little like debt. Preference shares differ from ordinary shares in that:

- they usually carry a fixed dividend, more like interest, which is paid before any other dividend is allocated; if this is added to the share balance rather than paid, they are 'cumulative preference shares';
- they may be withdrawable or (for companies) redeemable after a fixed period of time; however, they may also be transferable;
- there may be an option to convert them into ordinary shares after a period of time;
- they may have no voting rights, or limitations on participation;
- they may be paid before other shares in the event of dissolution – in other words, their holders are 'preferred'.

Preference shares need to be carefully defined in the governing document of the organisation or in a shareholder agreement, with advance from a legal expert. They are usually used to bringing in investors who want reduced risk and an opportunity to participate, but are prepared to defer repayment. They are usually only employed by companies.

If the shares are not listed on any exchange (there is some speculation that a social enterprise stock exchange may be formed in the future), finding a buyer can be difficult. The organisation might help by providing a 'matched bargain service', though this is still rare and not altogether reliable.

The possibility of speculation has led to the promotion of transferable shares being much more tightly regulated – see 6.6.2 below.

6.2.4: Membership shares

Of course, shares can be issued that are neither withdrawable nor transferable but are forfeited when the member leaves the organisation. These are the typical form of the shares in most common ownership co-operatives. From the point of view of raising finance, they are of limited worth since there is no reason for anyone to hold more than one; they rarely attract interest, though it is not impossible. However, if a co-operative attracts a very large membership they can make a significant contribution.

6.3: Consequences of equity

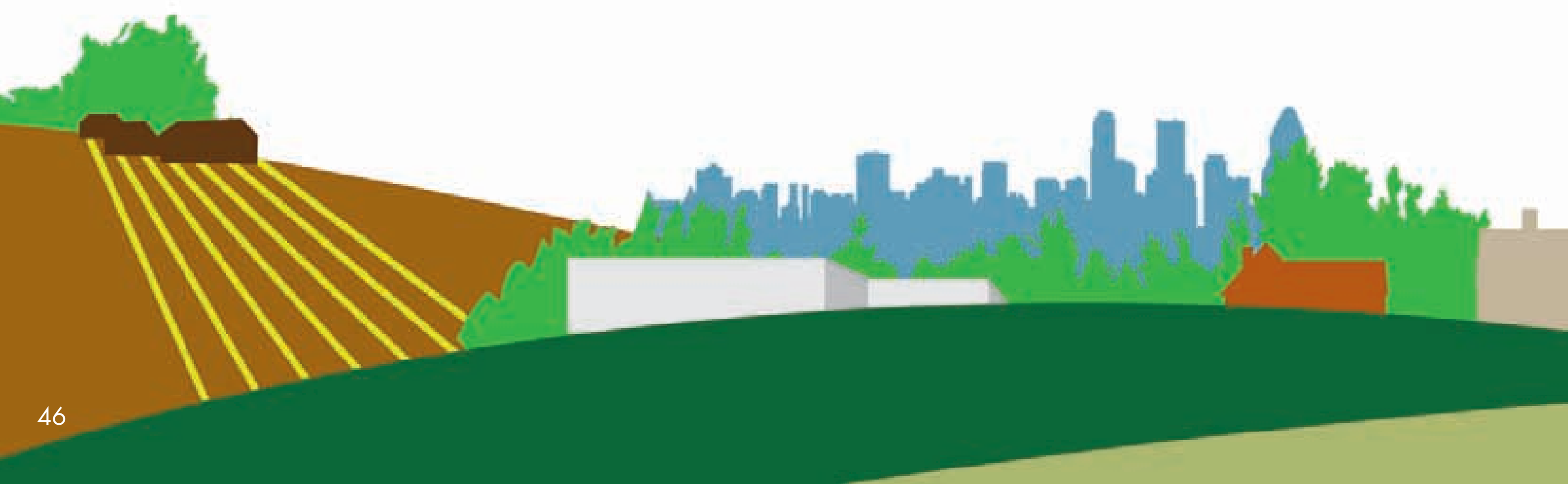
In the case of conventional companies, the possibility of accessing the wealth of the business through dividend or dissolution can mean that owners make the organisation increasingly concerned with short term profit. For socially responsible entrepreneurs, this is not a desirable outcome.

For many years it was assumed, not unreasonably, that this meant equity finance was quite inappropriate for co-operatives and social enterprises. This view has changed as a result of:

- the wider use of withdrawable share capital, which is not subject to speculation;
- social enterprises being unable to penetrate some sectors using debt alone;
- learning from organisations in other European countries that have issued equity without compromising their principles;
- community and consumer co-operatives built up experience of issuing small numbers of shares to a large body of people showing that finance could be provided by ordinary people;
- the emergence of a number of specialised social investors keen to obtain a more 'balanced return', supported by financial advisors with an interest in ethical investments.

The idea that a business should be 'proprietorial' – controlled by its owners – is actually just a convention. Organisations are best run by those who can most clearly see or experience the consequences of its actions.

Social enterprises have now developed increasingly sophisticated structures for separating ownership and control, and regulating access to profits. The aim is to acknowledge the risk taken by the investor, but keep the organisation focussed on its mission – not least by retaining a fair share of the profits to reinvest.



6.4: Shares and co-operation

Shares need not contradict the international principles that guide co-operatives, provided that the rules under which the shares are issued protect those principles.

Principle 1: Open membership to all who can make use of the co-operative's services.
Someone may wish to invest in a co-operative's shares, but not be a user of the co-operative's services. One solution is to widen the definition of the community from which the co-operative draws its users – for example, being a community co-operative rather than a workers' co-operative – but this may defeat the original purpose for which the co-operative was formed.

Instead, it is possible for co-operatives to have classes of share that have very limited voting rights but allow withdrawable or transferable investments. This creates a 'multi-stakeholder' co-operative in which people with different stakes in the business can contribute in different ways.

Principle 2: One member, one vote.
Conventional company shares convey voting strength in proportion to the number held, but this is not acceptable for a co-operative where small investors are considered of equal importance to large ones.

Whilst co-operatives will be one member, one vote, it is possible to have creative use of collective voting to ensure balance in multi-shareholder co-operatives.

Principle 3: Fair contribution to capital and distribution of profits, with some profits retained for future co-operators.
The terms of the shares would need to include limits on dividends, to ensure that reserves are built up in the co-operative and to ensure that rewards were no greater than necessary to attract and retain investment. They might also reserve some profits for distribution according to use of the co-operative.

An indivisible reserve: reserves that are indivisible cannot be distributed, under any form, both during the life of the co-operative and during its dissolution.

If subscription of a substantial amount of shares is a condition of membership for users of the co-operative, it should not treat some members differently to others or exclude a significant number of members by making membership unaffordable (offering a low interest loan from the co-operative to the member to cover the purchase of shares might be one way of avoiding that).

The retention of an indivisible reserve should be clearly specified in the rules, and ideally protected with a regulated asset lock. If there is no regulator, the rules could specify an 'asset guardian' that is the ultimate beneficiary of the reserve if the co-operative is dissolved.

Co-operatives often pay a dividend to their members from profits; however, this is quite different to the dividends paid to investors, as it is based on the members' transactions with the society. It is, in effect, a discount on internal sales rather than a return on investment.

There are no exact limits in law as to what rewards to investors are legitimate, but many understand 'no more than is necessary to attract and retain investment' to suggest that there should be a cap on interest payments a few points higher than the lending rate of a high street bank.

Principle 4: Autonomy and independence.
The co-operative needs to be confident that large investors cannot use their financial muscle to destabilise the co-operative. That might mean restrictions on the proportion of share capital that can be held by one person or organisation, or a veto on the transfer of shares to persons that the co-operative does not approve of. And in the case of co-operative companies it might also involve measures to prevent speculation on the value of shares, most importantly by preventing non-users from voting on a motion to dissolve the co-operative.

Principle 5: Education.
No great implications for equity investment, beyond the opportunity for investors to learn more about the wider co-operative movement.

Principle 6: Co-operation between co-operatives.
Some co-operative share issues have greatly benefited from investment by other co-operatives. This is helpful in forging close and supportive links, and a good way for successful co-operatives to use reserves for diversification.

Principle 7: Concern for the community.
Again, it is important that the rules do not enable investors to pursue short term profit over the long term and the concern for the community, by limiting their influence on day to day decision making.

6.5: Legal structures used for share issues

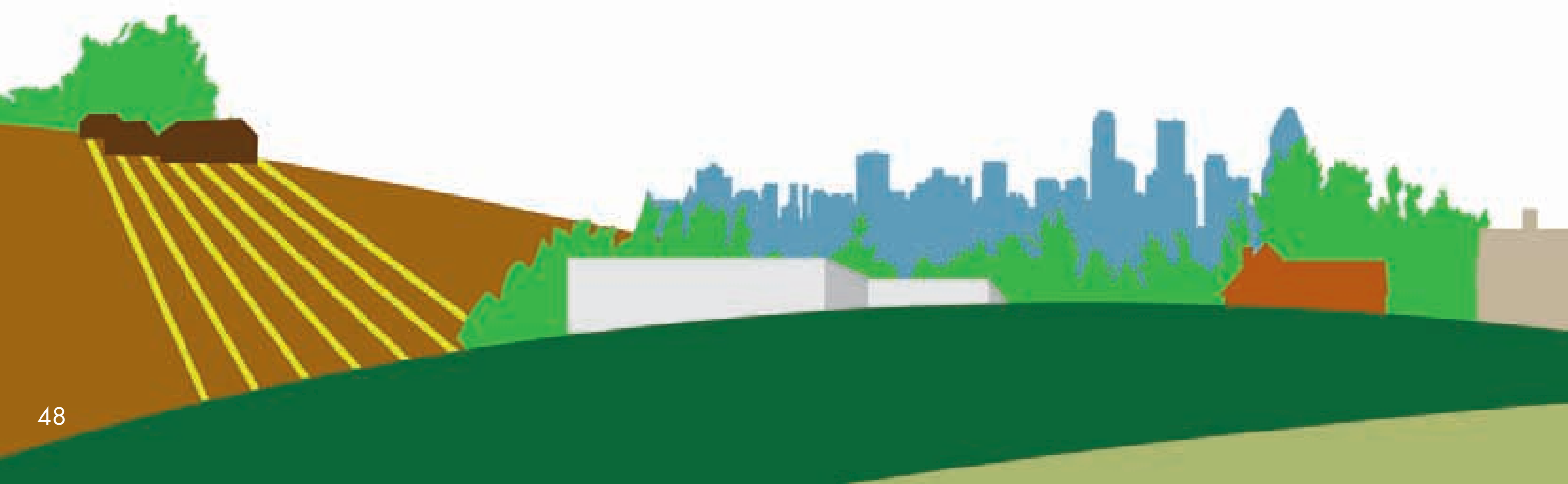
The actual mechanics of equity investment differs quite substantially depending on the legal form used. It is wise to consider future requirements for share finance at the point the organisation registers its legal structure. These are the main options available:

6.5.1: Co-operative and Community Benefit Societies

Co-operative and Community Benefit Societies (which were until 2011 known as Industrial and Provident Societies) are corporate bodies with limited liability that are the less well known alternative to companies.

They are currently registered by the Financial Services Authority (the future of which, at the time of writing, is being reviewed). They are favoured for social purposes because of their inherently democratic nature (all members have one equal vote each) and the limitations on the distribution of profits.

They come in two basic forms: the Co-operative, and the Community Benefit Society (or Bencom for short). The difference is that while Co-operatives are self-help, mutual aid organisations, Bencoms are intended for delivering wider benefits, and may be charitable in nature.



Case Study: Baywind Energy Co-operative Limited

A good case study is the Baywind Energy Co-operative Limited, the first of a series of large scale wind turbine developments managed by co-operatives under the umbrella of Energy 4 All. Energy 4 All is a secondary co-operative, and Baywind and the other projects are its members. The private sector partners involved are Triodos Renewables plc and Vindkompaniet, the Swedish manufacturer of the plant. Unusually, the co-operative was formed at the instigation of the manufacturer – it is an arrangement that they are used to working with in Sweden.

Initially, the finance was provided by Triodos, who formed a special purpose vehicle (Harlock Hill Ltd) with Vindkompaniet (Triodos having 80%). However, local enthusiasm for a co-operative proved to be present in abundance, and the the new co-operative raised £1.2 million finance with a share issue (aimed at, but not restricted to, the local community) buying part of the overall development. The shares were transferable, but also withdrawable after a period of time, so investors had good options for their 'exit'.

HHL become a service company, which had a guaranteed contract to operate the wind farm for five years; after that, Baywind could change the arrangement if it wished. As its resources permitted, it went on to buy more plant from Triodos in 1998.

Energy 4 All was formed with the aid of grant funding to help this and other wind farms produce authorised prospectuses and secure planning permission; it would charge for these services, generating the profit necessary to invest in developing new projects.

This model proved effective in some key respects; the autonomy of the local projects ensured that local communities could see that profits were being ploughed back into their locality and gave them loyalty to the development. The manufacturer made sales they might otherwise not have done, and had little difficulty exiting from the location as the well-financed co-operative took on more and more of the ownership.

Because it is easier to offer members a way to end their involvement, most rely on the unique ability of the Co-operative and Community Benefit Societies to issue withdrawable share capital, or simple membership shares.

While both Co-operatives and Community Benefit Societies can pay interest on withdrawable shares, a feature of the law is that this must not be the primary purpose of the society. Co-operatives must be carrying on a genuine trade or business activity, and Community Benefit Societies must pay only modest compensation to their members and keep their main focus on the benefit to the community.

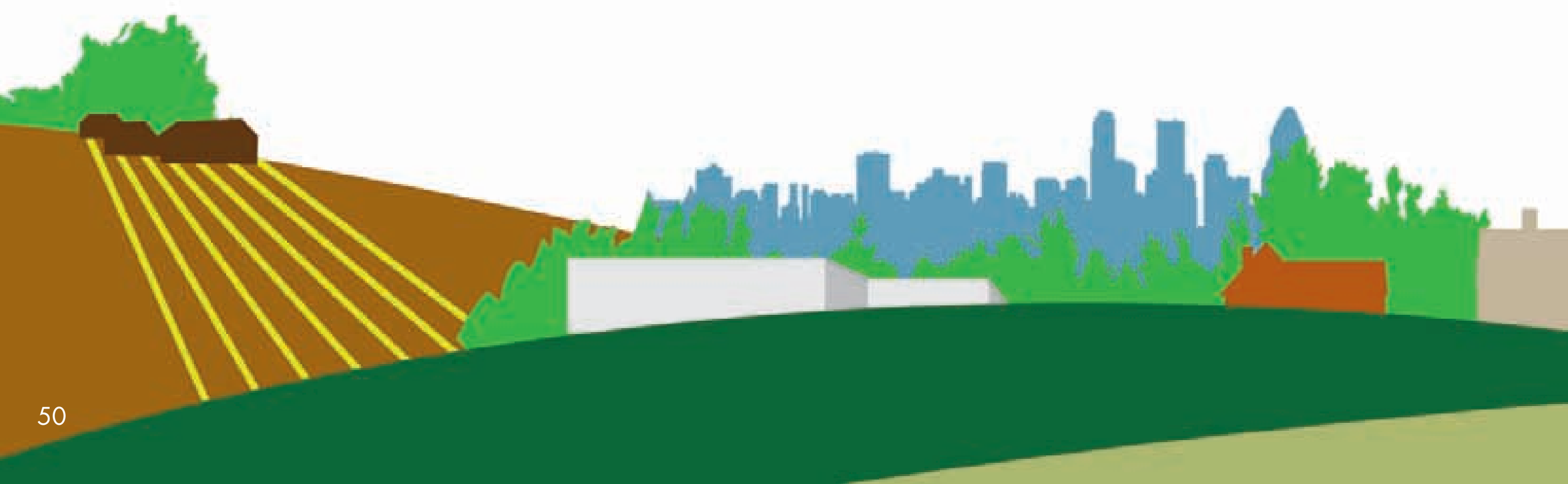
Co-operatives and Community Benefit Societies can both offer transferable shares as well; however, Bencoms have an exemption from the regulation of transferable share issues that co-operatives generally cannot call upon, and the option of a 'statutory asset lock' that will limit any rise in value of those shares. Promotion of financial securities is discussed in more detail below.

A significant limitation of this legal form is the £20,000 limit on share capital issued to any one investor. There is good reason to think this may be increased soon, but in any case there are some important ways in which organisations and individuals wishing to invest larger sums can be accommodated:

- there is an exception for organisations that are themselves Co-operative or Community Benefit Societies; they can invest more than £20,000.

6.5.2: Companies limited by shares, including CICs and plcs

For share issues the company limited by shares is the traditional form, used by countless businesses to agree the sharing of risk in a joint undertaking. Experience with speculative investment 'bubbles' led to a strengthened form of regulation for companies that wished to make their offer of equity to the general public – the Public Limited Company, or plc. Today, most of the large businesses that dominate their sector use the plc format to prove their worthiness to potential investors. To become a plc requires substantial resources (a minimum subscribed share capital of £50,000) and you should seek professional advice. The advice here is limited to private companies limited by share.



More recently, the Community Interest Company has been introduced to enable companies to prove and improve their social performance and work to a social mission rather than merely enrich their members. CICs can be both Companies Limited by Guarantee (which is most common) or limited by share; CICs can even be plcs, though this would be quite unusual.

CICs are best used when strong external regulation of a social mission is wanted; otherwise, the reporting requirements are going to be onerous and a drain on resources. There are some difficulties in amending CIC rules to satisfy co-operative standards of democracy, but they are not generally considered insurmountable, and model rules for a co-operative CIC are available; however, a co-operative CIC cannot put its members' interests first as a co-operative might be expected to.

They have a well-regulated asset lock, but this can make issuing share capital difficult. They cannot issue withdrawable shares, and the combination of capped dividend payments and no access to reserves on dissolution means that it could be hard to find a buyer for transferable shares. The cap, which applies to all dividends except those paid to bodies that are themselves asset-locked, has four elements:

1. The maximum dividend per share limits the amount of dividend that can be paid on any given share. Currently, the limit is 20% of the paid-up value of shares.

2. If interest paid on debt is variable dependent on performance, it can be no more than 10% of overall debt.

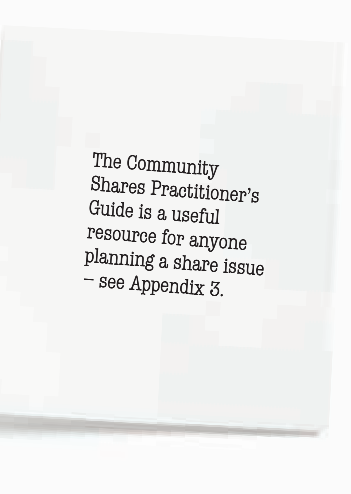
3. The maximum aggregate dividend limits the total dividend declared in terms of the profits available for distribution. Currently, the limit is 35% of the distributable profits.

4. The ability to carry forward unused dividend capacity from year to year to a limited extent. Currently the limit is 5 years.

Other companies are free to pay dividends to investors in accordance with the law on distributable profits and their own governing document.

6.5.3: Limited Liability Partnerships (LLP)

Limited Liability Partnerships are a form of incorporated body that is like a company in most respects except that its profits are taxed through its individual members' income tax rather than through corporation tax. It may have a partnership agreement specifying profit sharing arrangements rather than shares as such.



LLPs are profit distributing entities and so relatively rarely used in the social and community enterprise sector. However, their lightweight administration and relief from some company regulation makes them attractive for some purposes. In some cases the members of an LLP are themselves corporate bodies, using the LLP to share profits from a joint venture and limit their liability to the amount of their initial stake.

6.6: Carrying out a share issue

Share issues can be carried out in a number of different ways, in order to ensure that the funds are raised when they are needed and in a way that suits prospective investors. Some of the main questions to resolve are:

- is the offer time bound, with a closing date, or open to new investment at any time?
- is there a minimum sum to be raised, with smaller amounts being returned if it is not met?
- is there a maximum sum, beyond which further investment will not be accepted?

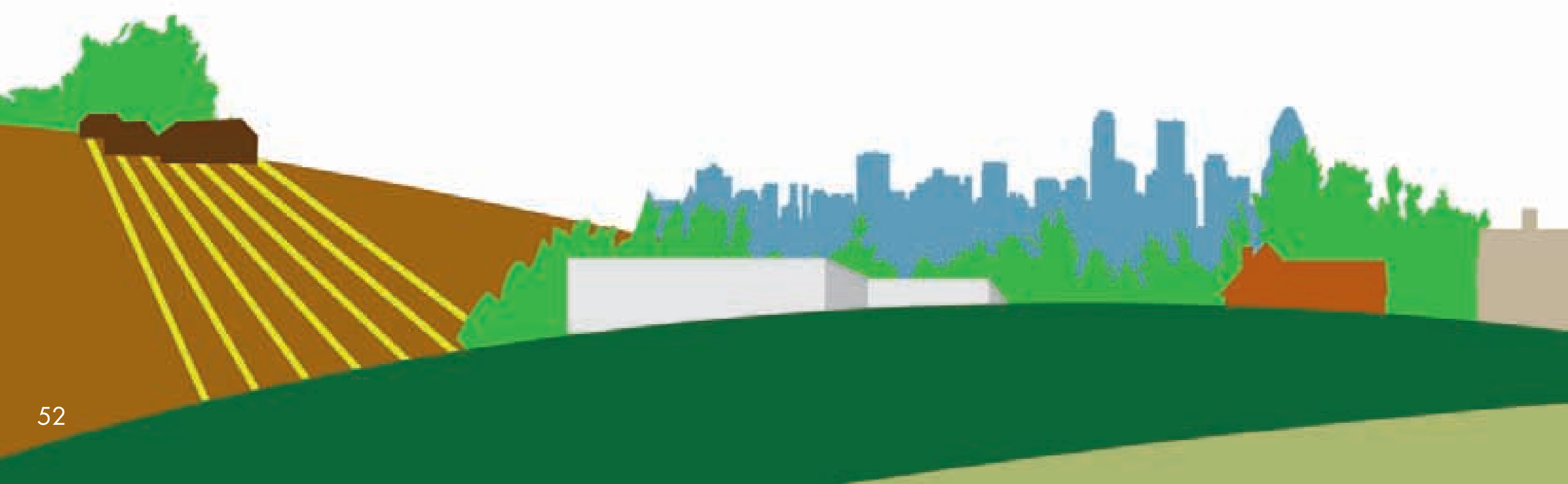
A share issue can be publicised to the appropriate investors, often via intermediaries such as financial advisors, investment matching services, and social investment networks. Many of the organisations that can arrange introductions to investors will want a commission for doing so; 3% to 5% of the sums raised is not unusual.

The big question is: will the issue be attractive to investors? They will look at the performance of the sector, the success record of similar enterprises, the expected returns (monetary and social) and the quality of the management team. It may also be an issue whether you have, or are associated with, any known 'brands'. Name recognition will boost investor confidence. Larger and experienced investors will study the business plan in much the same way as a bank would.

6.6.1: Corporate shareholders

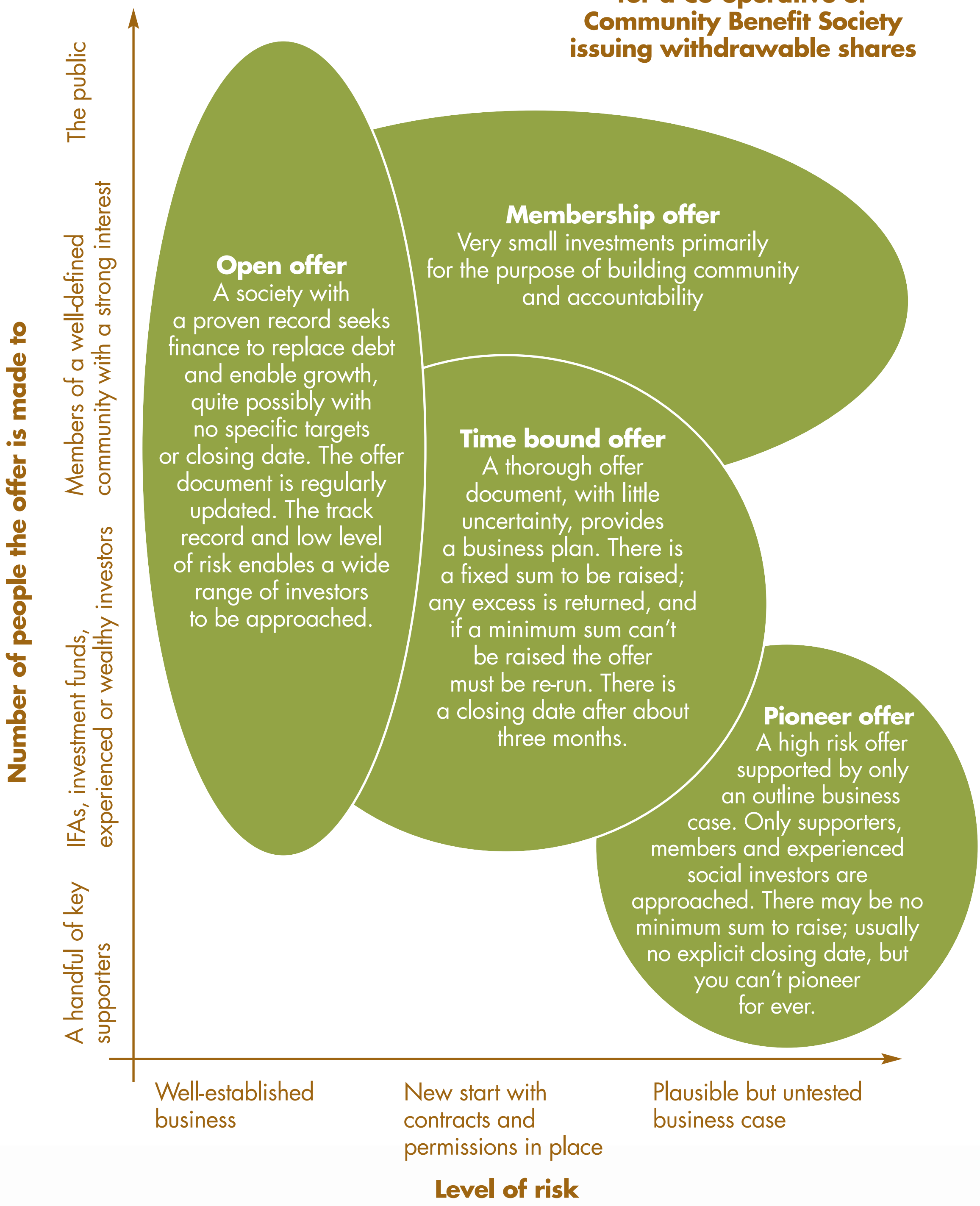
Shares can be held by individuals or by corporate investors. In the case of corporate investors, they will be represented in general meetings by deputies. Those deputies can then be elected to the governing body as though they were themselves members, though the governing document will often provide that if their nominating organisation withdraws their support, the deputy will have to stand down.

An increasing number of charities and social enterprises are now making 'programme related investments'. Rather than simply investing their reserves for maximum financial benefit, they are investigating whether there are investments that, while providing adequate returns, can also further the charities' aims.

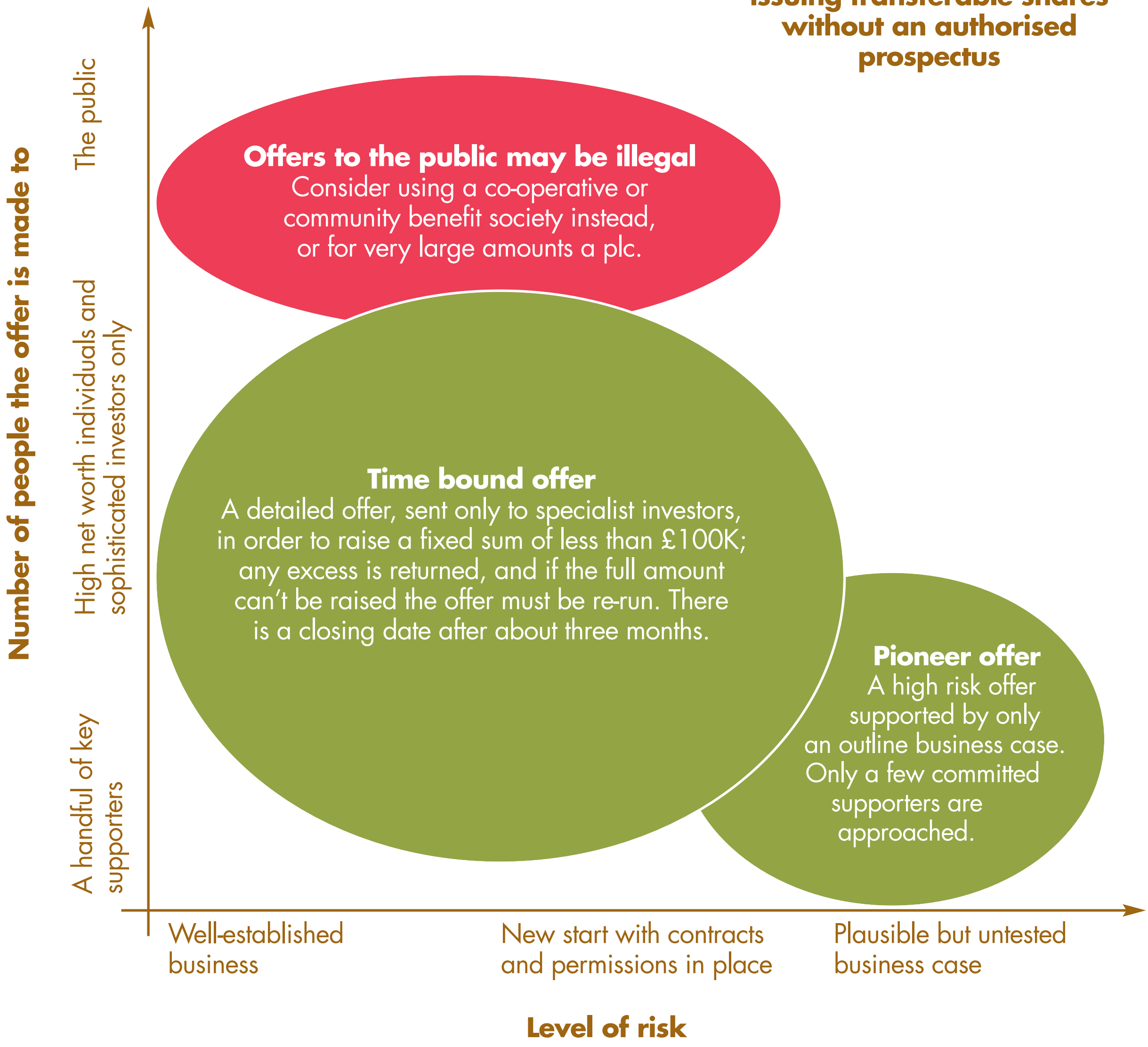


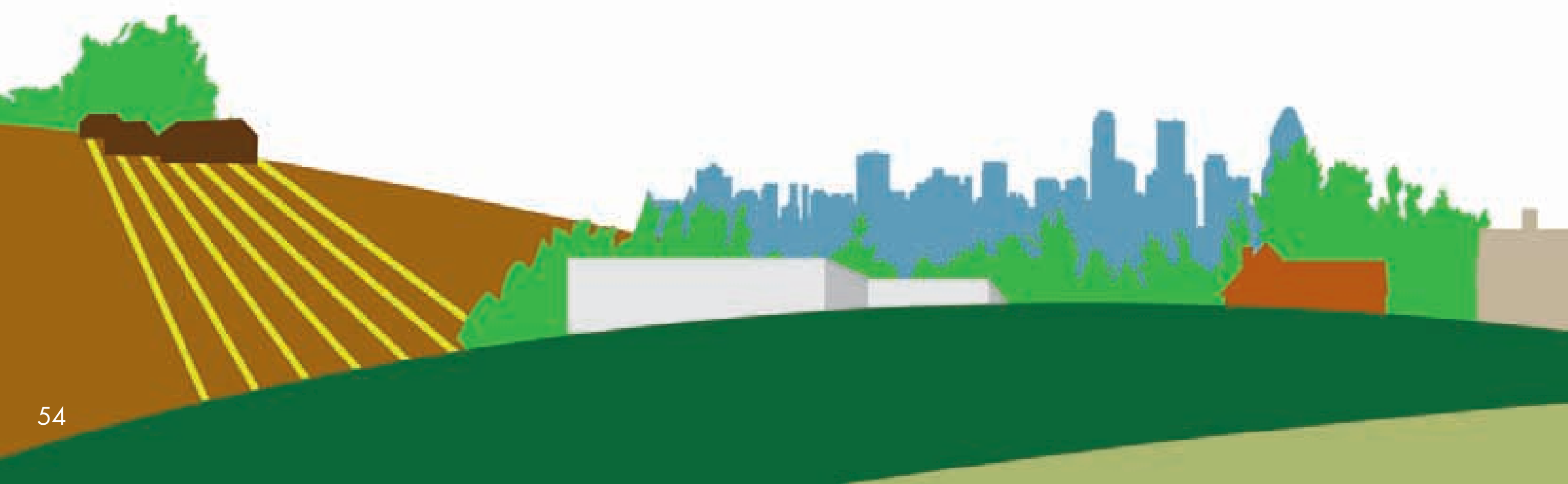
6.6: Carrying out a share issue

Different types of share offer for a Co-operative or Community Benefit Society issuing withdrawable shares



Different types of share offer for a private company limited by shares issuing transferable shares without an authorised prospectus





6.6.2: Legal restrictions on marketing securities

Any promotion or advertising of your shares will be subject to laws designed to protect unwary investors. It is very important to comply with the laws, as the consequences could be very severe – unauthorised controlled investment is a criminal offence.

Share issues are of widely varying cost and complexity. By following the law correctly, it is possible to issue shares without expensive legal advice, outside regulation, formal publications or share certificates but just an annual statement on the balance of each member's share account. However, even small projects may find that some of the things they would like to do are tightly regulated.

The largest issues carried out by social enterprises, of around £5 million, require advertisement to the general public, specialised legal structures (up to and including a Plc, as used by Café Direct), and intense legal scrutiny to ensure compliance with prospectus regulations. Some suggested figures are £100K for accounting and management, £100K for legal costs, the organisation's own management costs and however much you spend on marketing the issue (which could be in the vicinity of £100K). The money might well start to come in within six weeks of the main expenses being incurred, so some of the costs can be met from the share issue itself (provided there is confidence that any minimum will be met).

The difference is one of the quantity of money you are seeking to raise, but it is also a matter of the regulatory obligations. It is vital for small share issues to have a legal structure with low costs of regulation and compliance, otherwise a large portion of the funds raised will be offset by the cost of raising them. As a rule of thumb, if the cost of the promotion will be more than 10% of the sum raised, a different route should be found.

6.6.3: The laws that affect share issues

Regulation comes from four main sources: banking laws that prevent 'deposit taking' by anyone other than an authorised firm; the Financial Services and Marketing Act 2000 (FSMA), which protects consumers; the prospectus regulations, which require documentation for a regulated share issue to reach a high standard; and laws on fraud and misrepresentation, which could be used against you if any statements you made in the course of the issue were false, incomplete or dishonest.

Regulation is most tightly applied to unsolicited, real time communications – for example, cold calling or stopping passers-by on the High Street. These should always be avoided (though one-off instances are exempt, for example if the subject happens to come up in a conversation).

A self-certification form for sophisticated investors is included in Appendix 4.

The last will always apply, no matter how large or small the share issue, and you are strongly advised to:

- produce a document explaining the offer, and never rely on verbal or informal information alone;
- create a further internal verification document by checking through the explanation document line by line to ensure that every statement is verifiably correct, there are no relevant facts omitted, and nothing in it conveys a misleading impression;
- retain the verification document in case you need to produce it at a later date.

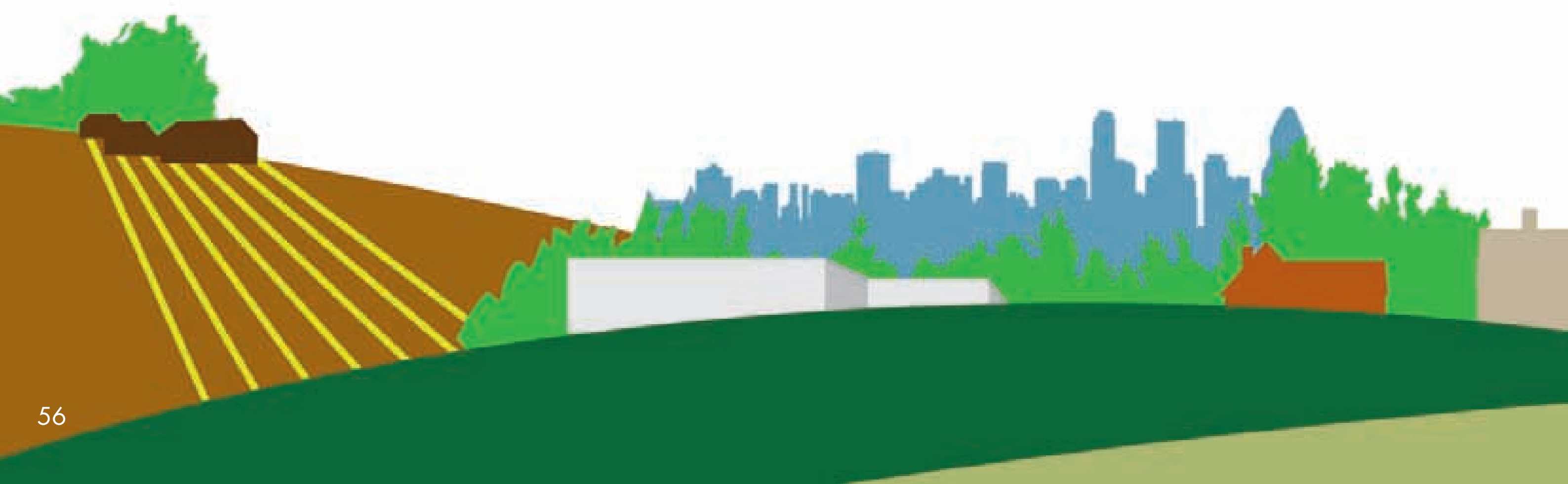
Note also that although financial promotion regulations are most commonly cited in the context of share issues, they also apply to 'debt securities' as well, including loan stock, bonds and debentures (prospectuses, however, are only required for transferable securities).

Redeemable debt securities may also fall foul of regulations on deposit taking. If, for example, you were to offer loan stock on request at any time, it could be argued that you were acting as an unauthorised deposit taker. Co-operative and Community Benefit Society withdrawable shares, issued as risk capital, are exempt from such regulation, as are issues for a specific, one-off purpose or in connection with membership.

6.6.4: Unregulated investors

There are, however, some financial promotions that are currently exempt from the FSMA and the prospectus regulations, although financial promotion rules might apply:

- non-transferable shares or debt securities (i.e. loan stock) issued by a Co-operative Society;
- any securities (i.e. shares or loan stock) issued by a Community Benefit Society;
- investments made by high net worth individuals (HNWI). Someone who has certified themselves as a HNWI by claiming to have an annual salary of £100K or net assets of £250K has waived their protection under FSMA;
- investments made by sophisticated investors (SI). Again, SIs can self-certify themselves as such if they have passed on of a number of qualifying actions, such as being professionally involved in business finance, being a director of a company with a £1M+ turnover, or having made an investment in any unlisted security in the previous two years;
- any communication to someone who is already a shareholder or creditor or (in most cases) an employee;
- investment by any body corporate with more than 20 members and net assets over £500K;
- investment by an unincorporated association or partnership with net assets over £5M;



- investment by a trust with gross assets in excess of £10M;
- a promotion in which fewer than 100 people are approached;
- a promotion in which the total sum being raised is less than ⇔100,000 (full prospectus regulations apply over ⇔2.5M; an authorised advisor is required for sums over ⇔100,000).

If you are relying on the exemptions relating to High Net Worth Individuals or Sophisticated Investors, any written materials you produce should include this disclaimer: "The content of this promotion has not been approved by an authorised person within the meaning of the Financial Services and Markets Act 2000. Reliance on this promotion for the purpose of engaging in any investment activity may expose an individual to a significant risk of losing all of the property or other assets invested".

6.6.5: Special purpose share funds

Sometimes it is desirable to raise funds for part, rather than all, of the activities of an organisation. Investors may wish to support one activity, without being exposed to the risk from another. This can be done by identifying shares as being for 'a special purpose' (ideally, provision for this will exist in the rules of the co-operative – if not, it is especially important to make it clear in the conditions of the shares at the point they are applied for).

If a loss is recorded on that business activity, those shares may be reduced in value while other shares are unaffected; the same applies in reverse. The protection is not absolute – the funds are still at risk if the organisation as a whole becomes insolvent – but it does mean that profits and losses can be 'focussed' on the investors that financed the activity that generated them. For clearer separation of different business activities, consider using special purpose vehicles as described in 6.8 (Joint ventures).

Co-operative dividends, which are paid to members in proportion to their transactions with the society, are quite different to investor dividends. The co-operative dividend is intended as a more equitable way to distribute profits, because it does not favour those with capital to invest.

6.7: Payment of dividends and interest

Once the organisation has recorded some profit, and has covered any losses and profit distributions from previous years, it may decide to make a payment of dividend (or in the case of withdrawable shares and debentures, pay discretionary interest). It may be hard to see at first why an organisation would be at all generous, rather than simply reinvesting as much profit as possible. The answer is that a track record of paying dividends is one of the key motivators that persuades the large body of risk-averse investors to support future share issues. If you hope to expand in the future, and expect to use equity to achieve it, it helps to be able to show solid dividend payments in the recent past.

A common way for investors to weigh up the value of a proposed investment is the 'internal rate of return'. This calculation, which can be carried out using most spreadsheet software, takes into consideration the value and the timing of:

- the initial subscription, which is expressed as a negative figure
- the expected 'exit' – the sale or withdrawal of shares
- dividends or interest payments
- tax reliefs

The calculation returns a single percentage figure which can be compared with alternative investments: including, for example, the interest that could be obtained in a savings account. It takes into account the fact that although a 10% dividend may sound good, it is less valuable if you have to wait five years to get it. Early payment of even small dividends can be helpful in showing a healthy internal rate of return.

The governing body will normally take a decision on how much of the profits to distribute, and hence what level of return to make. However, best practice is to make this into a formal resolution at a General Meeting of the organisation.

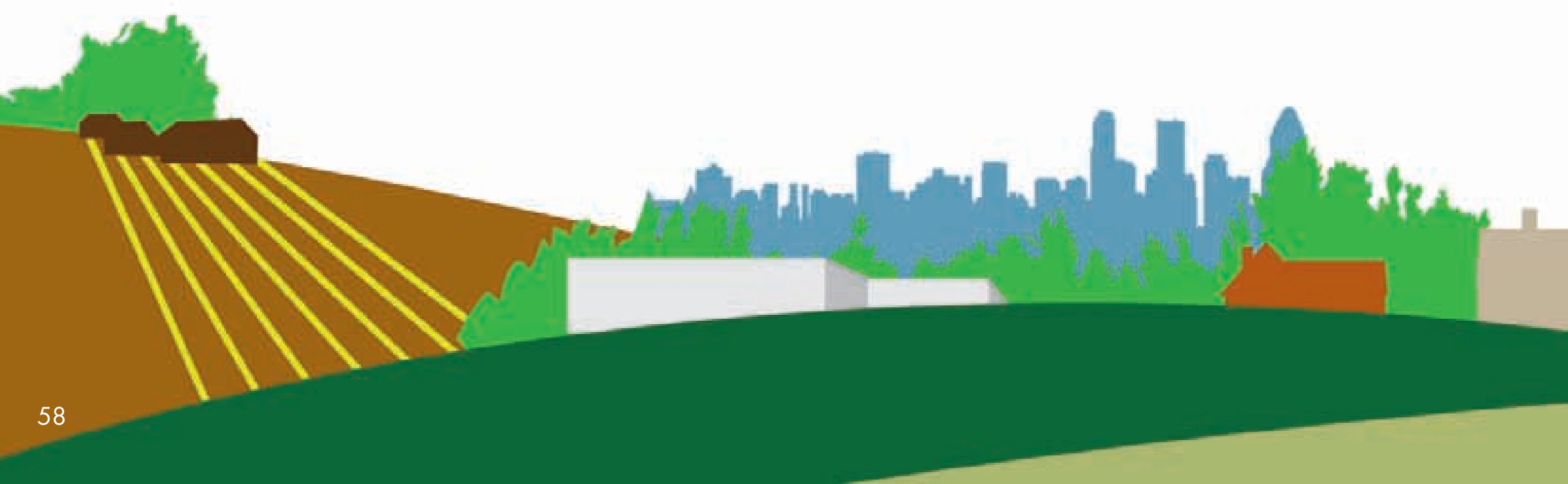
6.8: Joint ventures

It is obviously desirable to ensure that all the activities your organisation engages in are entirely owned and controlled by a legal structure that fully reflects your values. However, it isn't always possible, if the key sources of equity finance involved are determined to maintain a for-profit ownership of their share of the business activity (or for other reasons have a separate identity), or if the business sector being entered requires specialist expertise or credibility that is just not available in the social and community enterprise sector.

6.8.1: Forming partnerships between organisations

Available partners, often industry specialists with long track records and strong reserves, may wish to support the new venture. However, the precise relationship needs to be carefully defined. Among the issues are:

- **branding.** Is the organisation seeking to be a supplier to multiple brands, or does it seek to own and develop brands itself? Its members may well expect brand values to be applied throughout the supply chain as far as possible. For this reason it is better to have clarity and honesty over the limits of its influence.



- **instability.** Can the private sector partner transfer its holdings? Is the partner in danger of reputational or business failure? Might the partner be bought by another entity with different intentions? If the private partner has no control over the joint venture, it will expect an exit route – could replacement finance be obtained at short notice?
- **separation of tasks.** Partners may be available for some of the projects the organisation is undertaking, but not others. It may be necessary to split the organisation to make a partnership effective.
- **pricing.** If a private investor is buying a share of the organisation, what valuation of the existing organisation is this based on? If it is low, it may have to give up a great deal of control in order to raise the funds it needs. If the organisation needs to attract future funds, too high a valuation could make it vulnerable to falls: its future would depend on the value placed on it by outsiders.

The simplest joint venture is a partnership governed by a simple profit sharing agreement. However, this does not provide the partners with limited liability, or a distinct 'legal identity'.

6.8.2: Special Purpose Vehicles

Another step down this road is to form a subsidiary company to carry out a trade between several partners, one or more of which might be social or community enterprise. This kind of 'special purpose vehicle' would conduct the trade as an incorporated body in its own right. Special purpose vehicles (SPV) offer significant benefits in terms of mobilising local participation and support; protecting the core business from debt and risk; and building partnerships with other businesses that bring expertise, assets or access to finance. The following safeguards should be observed:

- if possible, the SPV should have the same standards of social responsibility, and means for enforcing them, as its parent. Otherwise the SPV could behave in ways that bring the parents into disrepute.
- be aware that any funds invested using Enterprise Investment Scheme (see chapter 8.2.1) must be employed in a qualifying trade by the organisation they were invested in, or by a 90% owned subsidiary. If the SPV is less than 90% owned by the organisation, it must ensure that its income (from which investors will gain returns) does not come from investment or financial services, but from a real trade. That could include consultancy and business development carried out for the SPV, which could be paid as a commission on the SPV's operations.

- care should be taken to ensure that support for the local project does not eclipse the 'parent' organisation, which needs to be able to reinvest in connecting services, and developments elsewhere. One way to do this is to create a significant overlap between the membership of the SPV and the parent, and the opportunity for some profit to flow back to the parent organisation. One way to do this would be for all applications for membership of the SPV to be made to the parent organisation, which would then act as an 'approved nominee' in the SPV.
- debt finance can be used by the special purpose vehicle as well as equity. Debt may be preferable to large investor equity because it will demand less of the profits over the long term. See chapter 5.2.

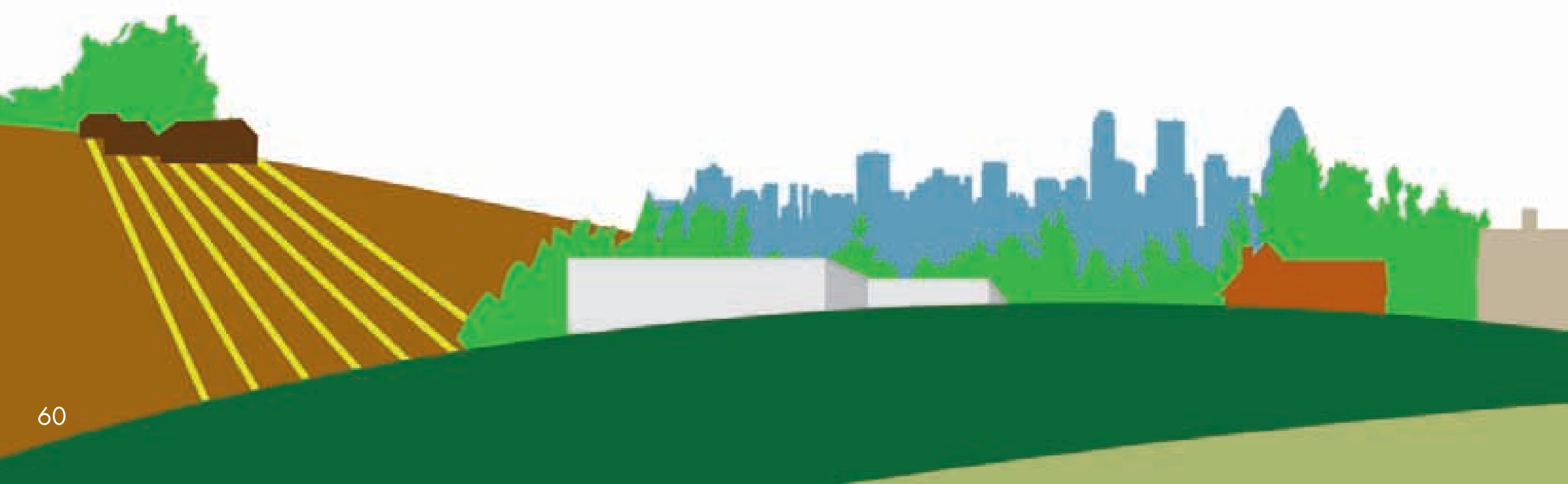
6.9: Property leases as a form of equity

Organisations investing in property – whether housing or workspace – can raise a kind of equity from tenants by offering long leases purchased with a one-off sum instead of rental payments. This has the advantage of reducing the capital required to acquire the property in the first place; but unlike true equity it makes borrowing funds harder because the organisation has effectively reduced its assets by handing rights over them to someone else.

A lease is transferable – it can be sold just like the freehold – and if it is of sufficient length (99 year leases, or even 999 year leases, are quite common) it can feel very much like full ownership (for example, leaseholders may be able to secure a mortgage of their own against their lease). You can put conditions in the leasehold agreement, allowing the organisation to:

- veto the transfer of the lease under certain conditions,
- require a service charge for maintaining shared facilities, or other provisions,
- or limit the profit that can be made in the event of resale.

However, too many of these conditions will damage the value of the lease.



Case Study: Green Valley Grocer

In early 2009 the owner of the greengrocers in Slaithwaite, West Yorkshire, decided to retire. The business had been gradually winding down for years beforehand and the community was concerned that nobody would buy the business and the greengrocers would disappear.

Not only would this mean the loss of a job but it would also be bad for the town's thriving high street – if the greengrocers disappeared, members of the community thought, people would have less reason to come into town and use other shops like the butchers or fishmongers.

"Nobody wanted to be a greengrocer," said Graham Mitchell, one of the residents who has worked to save the shop, "but nobody in the community wanted to lose the greengrocers either."

A small group of residents realised their best option was to bring the shop into community ownership. They began by putting the idea out through networks and, after getting a positive response, held a public meeting. Attended by around 60 people, there was overwhelming support for the community buying the shop.

Next, a core group developed a business plan and formed a co-operative that would enable the community to buy shares in the business, own and control it.

"Our projections indicated that we needed £15,000 to buy the fixtures and fittings from the current owner and get the business up and running," says Graham, "so we decided to do a share issue." "The shop shut on May 29 so we held a second public meeting that day, saying that if we could raise £15,000 in the next couple of weeks then we could re-open the greengrocers. By the middle of June we'd raised £18,000."

The co-operative had sold £10 shares to members of the community. It was made clear that buying shares in the co-operative was risky, but over 100 people invested in the business in those few weeks. The largest amount invested by a single member was around £1,500, but most invested £100 to £150. These members can now own and control the business and can stand for the board.

The co-operative paid £6,000 to the former owner for fixtures and fittings, and the new shop was opened on the 10th July 2009 by the Mayor, six weeks after it closed. The buyout has really brought the community together, says Graham. Members volunteered in advance of the shop opening, helping to sort out, refurbish and clean up the premises. Local businesses helped too – Graham's worker co-operative fronted some of the costs and another member of the co-operative, who is a structural engineer, offered over £5,000 worth of their time and expertise.

7 Documenting finance raised

All organisations should be keeping a cash book, showing how liquid funds come and go from the organisation. The arrival of finance should be clearly visible from the cash book. In this simplified example, an organisation receives a grant and a loan, and uses them to purchase a field on which to grow vegetables:

Table 1 **Summary Transactions**

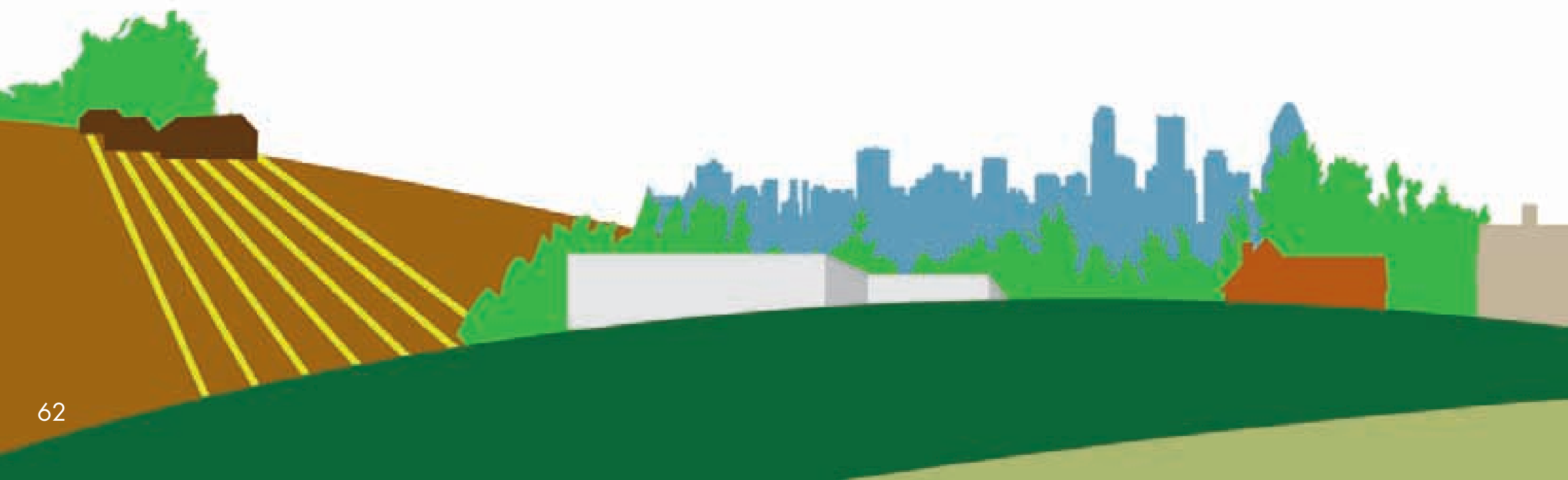
Date	Cash book	Income	Expenditure	Bank balance
01-Mar-10	Opening bank balance			£250.00
01-Mar-10	Lottery grant	£1,500.00		£1,750.00
05-Mar-10	Co-op bank loan	£2,500.00		£4,250.00
12-Mar-10	Purchase of land		£3,800.00	£450.00
14-Mar-10	Closing bank balance			£450.00

Outstanding purchases

18-Mar-10	Purchase of seed (on credit)		£78.92	

Loan repayments

Dec-10	Bank loan repayment 1 Year		£500.00	
Dec-10	Bank loan interest charge 1 Year		£500.00	
Dec-10	Bank loan repayment over 1 Year		£2000.00	



7.1: The balance sheet

This tells us very little about the true health of the organisation, only how much funds they have available to them. A more informative picture is given by a balance sheet, which shows the net worth of the organisation at a moment in time, and how that value is financed. The two totals should match, or 'balance' each other. Here is the same organisation viewed through its balance sheet on the 15th of March (at which point the seed had been purchased, but not yet paid for). The reserves are the resources of the organisation that belong to it and it alone; they are the accumulated profit from trading. In this case, you can see that they are made up of the grant (which has been used for the purpose intended, and so carries no further obligation), the opening balance and the trading loss (which itself is made up of the purchase of seed and the anticipated interest payments of £50 on the loan).

One thing we can see straight away is that this organisation is quite highly geared – about 60%. It would be much higher were it not for the grant and the reinvested profits. How can it improve this situation?

Imagine that the organisation secures another grant of £1,000 on the 20th of March, which is to run free training courses for local people. How does that change the net assets?

As you can see, nothing has changed. That is because, at this stage, the work that the grant was intended to fund has not been carried out.

Balance Sheet (based on table 1 transactions)

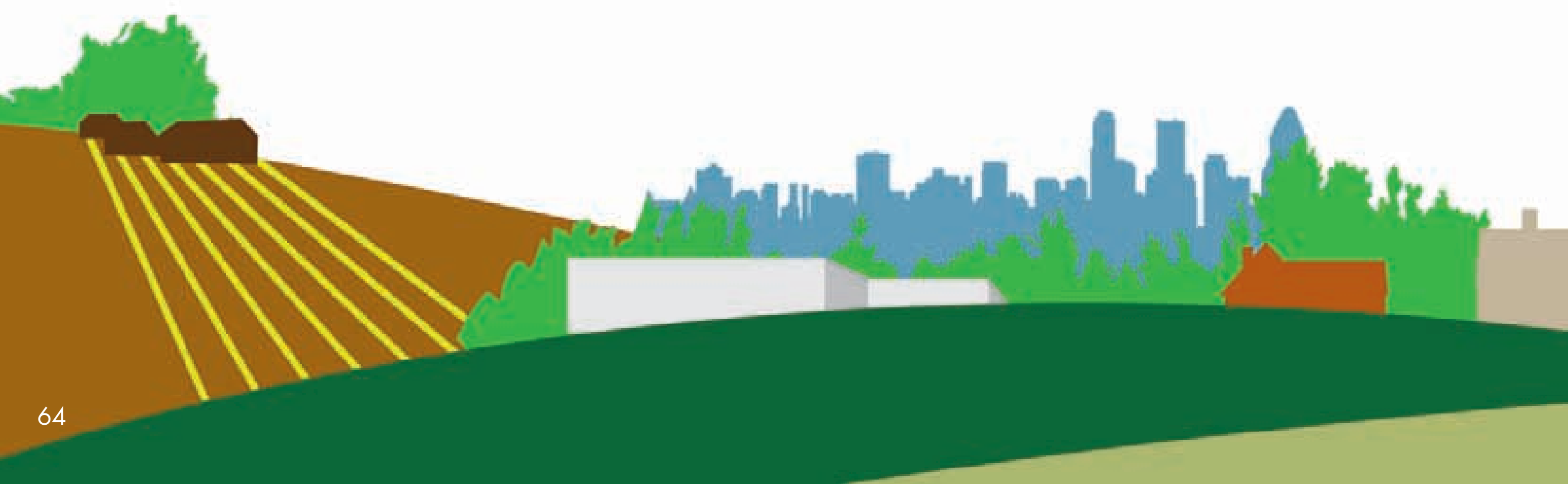
Fixed assets	Land		£3800.00
Current assets	Cash at bank	£450.00	
Current liabilities	Creditors (seeds) Bank loan repayment in 1 Year	£78.92 £550.00	
Net current assets/liabilities			£(178.92)
Long term liabilities	Bank loan repayment		£(2,000.00)
Net Current Assets			£1621.08
Financed by	Share capital Reserves		£15.00 £1606.08
			£1621.08

Table 2 **Summary of transactions**

Date	Cash book	Income	Expenditure	Bank balance
14-Mar-10	Opening bank balance			£450.00
20-Mar-10	Lottery grant (2)	£1,000.00		£1,450.00
20-Mar-10	Payment of seed creditor		£78.92	£1371.08

Balance Sheet (based on table 2 transactions)

Fixed assets	Land		£3800.00
Current assets	Cash at bank	£1371.08	
Current liabilities	Lottery grant (2) Bank loan repayment in 1 Year	£1000.00 £550.00	
Net current assets/liabilities			£(178.92)
Long term liabilities			£(2,000.00)
Net Current Assets			£1621.08
Financed by	Share capital Reserves		£15.00 £1606.08
			£1621.08



As the funds of the organisation are used to deliver the grant according to the budget agreed with the funder, the grant reserve liability will go down; but, most likely, so will the cash in the bank.

An issue of loan stock would improve the net current assets, because it is entirely a long term liability. However, it is debt and would only increase the gearing of the organisation, making anyone looking at the balance sheet increasingly concerned as to how the organisation will succeed in servicing all this debt.

A share issue to members would help. The fifteen members are each willing to purchase £100 of withdrawable shares. They hope to earn some interest on these, but that will be up to the governing body to decide when the organisation shows a profit.

Table 3 **Summary of transactions**

Date	Cash book	Income	Expenditure	Bank balance
14-Mar-10	Opening bank balance			£1,371.08
20-Mar-10	15 members pay £100 for shares	£1,500.00		£2,871.08

Balance Sheet (based on table 3 transactions)

Fixed assets	Land		£3800.00
Current assets	Cash at bank	£2871.08	
Current liabilities	Lottery grant (2) Bank loan repayment in 1 Year	£1000.00 £550.00	
Net current assets/liabilities			£1,321.08
Long term liabilities			£(2,000.00)
Net Current Assets			£3121.08
Financed by	Share capital Reserves		£1515.00 £1606.08
			£3121.08

Now the gearing ratio is 44%, which is more manageable. The organisation has enough funds to invest in generating profit, without too much of those profits being taken up with loan repayments. But those fifteen members have put their funds very much at risk – if things go wrong, they will not receive any funds until all creditors and lenders have been repaid in full. As long as the organisation has reserves, that should not be a problem. But if the reserves are reduced by a year or two of trading at a loss, they may become much more nervous.

7.2: Record keeping requirements

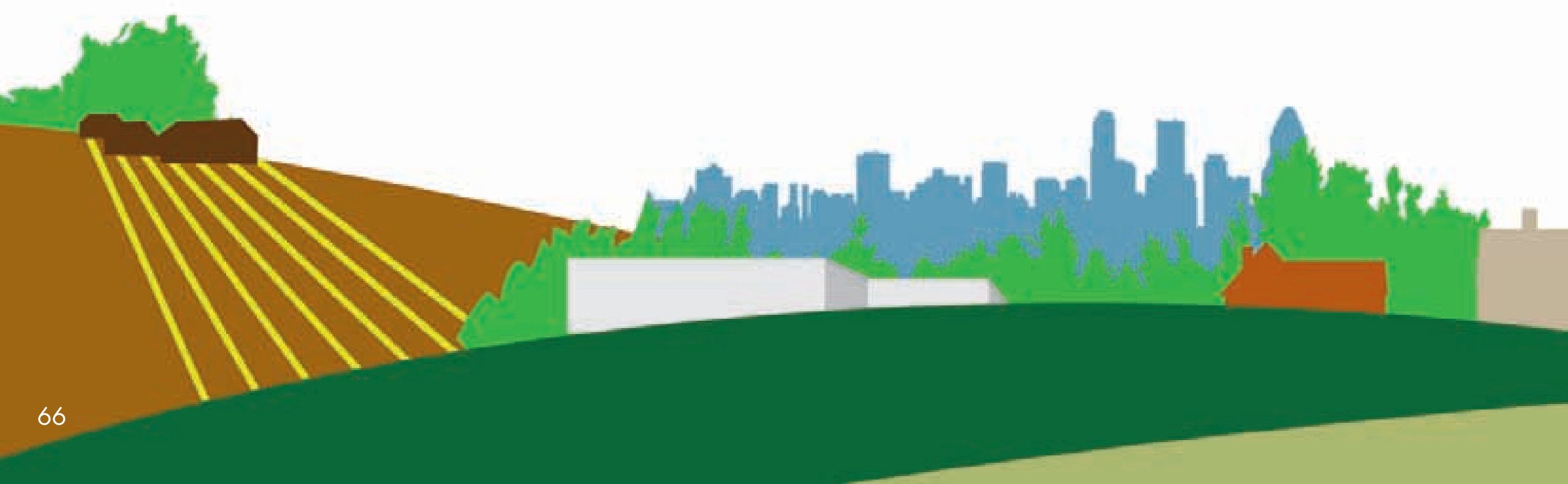
All finance imposes some obligations on record keeping as too does company law and other legislation (such as that for Co-operatives and Community Benefit Societies). Grant funders will expect that as well as your general accounts, you will be able to produce income and expenditure records in detail for the grant funded activity. This should be reasonably consistent with the budget you originally presented to them, and in particular should not show unfunded activities of the enterprise profiting from grants given for another purpose (other than by way of full-cost recovery as described in chapter 3.1).

Lenders often expect quarterly management accounts, which can be a challenge for businesses more used to producing annual accounts (and those after much delay). It is a worthwhile discipline to adopt, however, and can help all the participants in the organisation stay more closely in touch with which activities are working and which aren't. You should ensure that your copy of the loan agreement is kept in a safe place and easy to find, as well as any legal charge.

Bonds and loan stock are not usually provided for in governing documents (other than a general enabling power), so application forms should be used that clearly show the conditions of the issue. These application forms should be retained by the organisation, and a corresponding certificate issued. The certificates should be individually numbered and recorded in a register so that you can quickly see which are 'live' and which have been cancelled. A sample certificate is provided in Appendix 4.

Shares can be recorded in one of two ways: either you issue share certificates, in which case you will need to maintain a register of shares, showing which certificates were issued to whom and when; or you can dispense with share certificates and record share accounts, sending members a statement of their account each year. The latter is more suitable when the sums of money being handled are small, and the organisation is a Co-operative or Community Benefit Society. The governing document may specify certain records to be kept.

Application forms for shares should be used and retained. If you are dealing with people who are not well known to you,



you should have the agreement clearly spelt out; also, if there are conditions to the shares that are not clearly spelt out in the governing document, they can be recorded here. Lastly, you might also be called upon to prove that this income was not earnings subject to corporation tax.

7.3: Communication

One very good reason for keeping funders' contact details up to date and regularly maintaining the organisation's vital statistics is to communicate your achievements and your difficulties. Funders can be seen as having done their job once they have sent the cheque, but recipients can gain a great deal from nurturing a relationship: advice, publicity, contacts for further support, reputation, market intelligence and sympathy, to name but a few. The same applies to guarantors, suppliers and of course customers. Newsletters should be circulated on a regular basis, and as well as updating stakeholders on the latest developments, they can be used to introduce the people behind the organisation. Open days can be good opportunities to get to know supporters, as can Annual General Meetings – the need to conduct formal business need not be incompatible with a celebration of progress. The internet has made this type of regular communication even more flexible and interactive, with web forums, twitter accounts, blogs and more.

8 Tax efficient finance

The choices that an organisation makes regarding finance may have implications for the amount of tax that they, and their members, customers and supporters, end up paying. In general, this will not be the overriding concern in choosing forms of finance, but it is worth understanding some of the implications so that there are no unpleasant surprises. Taxes are applied both to businesses and to individuals connected with them; very often, what is tax efficient for the organisation is not what best suits individuals.

8.1: Business taxation

Businesses are subject to many different forms of taxation, and the forms of finance used to capitalise the organisation will have substantial implications for many of these. As well as the other considerations that may apply, finance should be tax efficient.

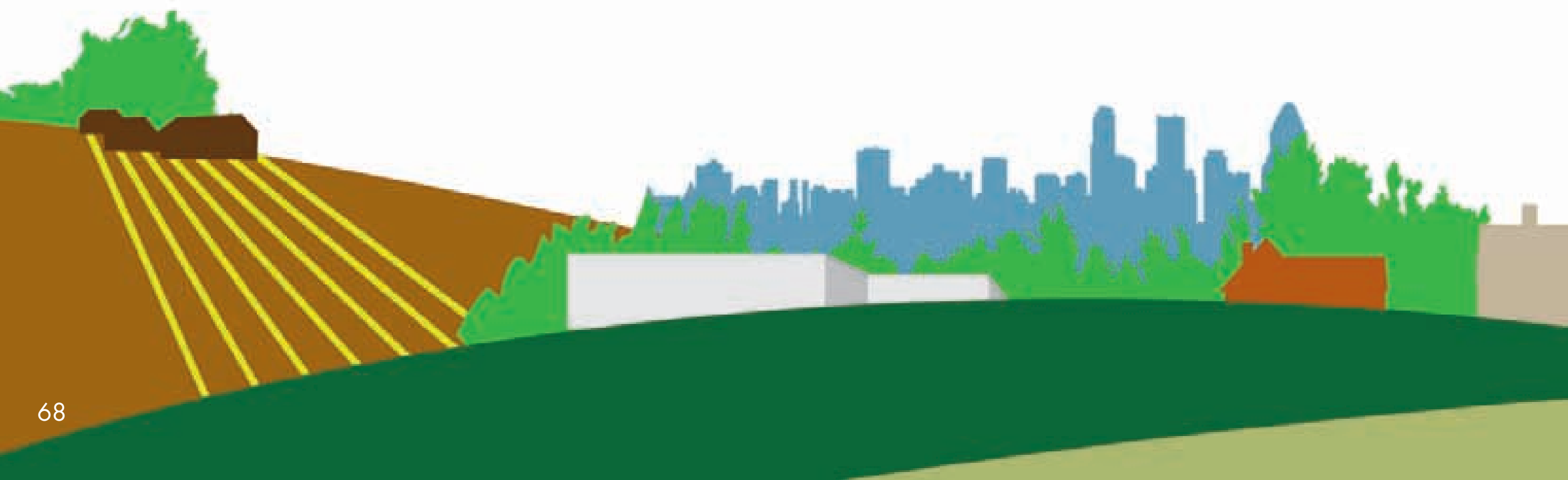
8.1.1: Corporation tax

This is a tax on profits, or to be precise, on certain types of profit. It is paid at a smaller level on modest profits than on very large ones. Interest payments on loans, bonds and withdrawable shares tend to reduce profits and hence reduce corporation tax exposure; dividends on transferable shares, by contrast, are paid after tax (though the effect of this in the overall picture for the shareholders is cancelled out by the lower rate of income tax paid on dividend income).

The actual receipt of a loan from a bank or other lender is not taxable because it is not income. However, the receipt of a grant from a funder is taxable if its function is to support or subsidise activities (such as a trade) which are themselves taxable. If for capital expenditure, the Inland Revenue may accept an offset of the relevant expenditure directly against the grant for tax purposes. If a grant is funding non-trading activities, such as charitable work, then it is probably not taxable.

Organisations which are fully mutual, such as credit unions and some housing co-operatives are not subject to corporation tax on trading income but are taxed on other forms of income, such as interest on investments. Fully mutual means that the organisation only trades with its members. See chapter 8.1.4 below.

Capital allowances encourage businesses to invest in plant and equipment, and can make buying assets attractive compared to leasing. By allowing expenditure on some fixed assets (and the rules are quite complex) to be 100% deductible from taxable profits, they in effect offer a significant contribution towards the cost. In the future, the asset will be a cost to the organisation as it will depreciate – but it will have a residual value beyond which it cannot lose much more value.



By comparison, lease payments provide you with no assets and are likely to be more than the equivalent depreciation. So whether or not it is wise to lease rather than buy depends on the type of finance available. If it is possible to raise the funds easily, without creating excessive gearing (see chapter 5.2), and the interest payments are less than the difference between the lease and depreciation, it is probably worthwhile (company cars require a different calculation, as special rules apply to both capital allowances and VAT).

8.1.2: VAT

Value added tax is both very simple and very complex. When you register for VAT, you are obliged to charge VAT on most goods and services that you offer for sale (known as output VAT). However, you can claim back VAT on most goods and services that you buy (this is known as input VAT). As long as your volume of trading is below the VAT threshold (currently £70,000), registration is optional. Above the threshold it is compulsory.

<table>
<tr><th>Type of supply</th><th>VAT status</th><th colspan="2">For example</th><th>Count towards threshold?</th></tr>
<tr><td>Non-business supplies</td><td>Outside the scope</td><td colspan="2">Work funded by grants or donations</td><td>No</td></tr>
<tr><td rowspan="5">Business supplies of goods or services</td><td>Exempt</td><td colspan="2">Education, healthcare, cultural services, charitable fundraising events, insurance, some rent</td><td>No</td></tr>
<tr><td rowspan="4">Taxable</td><td colspan="2">All business supplies that are not exempt</td><td>Yes</td></tr>
<tr><td>Zero rate</td><td>Food, books, children’s clothes, various supplies to charities (eg advertising)</td><td></td></tr>
<tr><td>Reduced rate</td><td>Tampons, various reliefs</td><td></td></tr>
<tr><td>Standard rate</td><td>All other supplies</td><td></td></tr>
</table>

'Zero rated' does not mean the same as 'exempt'. Exempt supplies also attract a zero rate, but you cannot use them as a justification to claim back VAT on your purchases.

You can opt for 'flat rate' VAT, in which case your sales will be taxed at the average level for your sector without your needing to provide information on your purchases. It is less paperwork, and will benefit an organisation that uses less VATable purchases (for example, by being more labour intensive) than its competitors.

This table shows the VAT status of different kinds of supplies, and whether they count towards the threshold for compulsory registration.

If customers are themselves mostly VAT registered businesses, there is little to be lost by registering – your customers being registered themselves will be able to claim back the tax you charge them, and you will be able to save money on the things you purchase. It is also worth making an early VAT registration if the goods being sold are mostly zero rated for VAT. If the organisation sells to individuals, VAT registration may create a competitive disadvantage and should be postponed until it is unavoidable.

If your enterprise is VAT registered then VAT on purchases is not a cost to you as you should be able to reclaim any VAT incurred. It follows that in accounting for any grant funding, you should include the costs net of VAT. That said, if a proportion of income of your enterprise is outside the scope or exempt for VAT then this could reduce the amount of input tax that you are able to recover. If you are unsure about this then it may be worth obtaining specialist advice as VAT errors can be expensive to rectify.

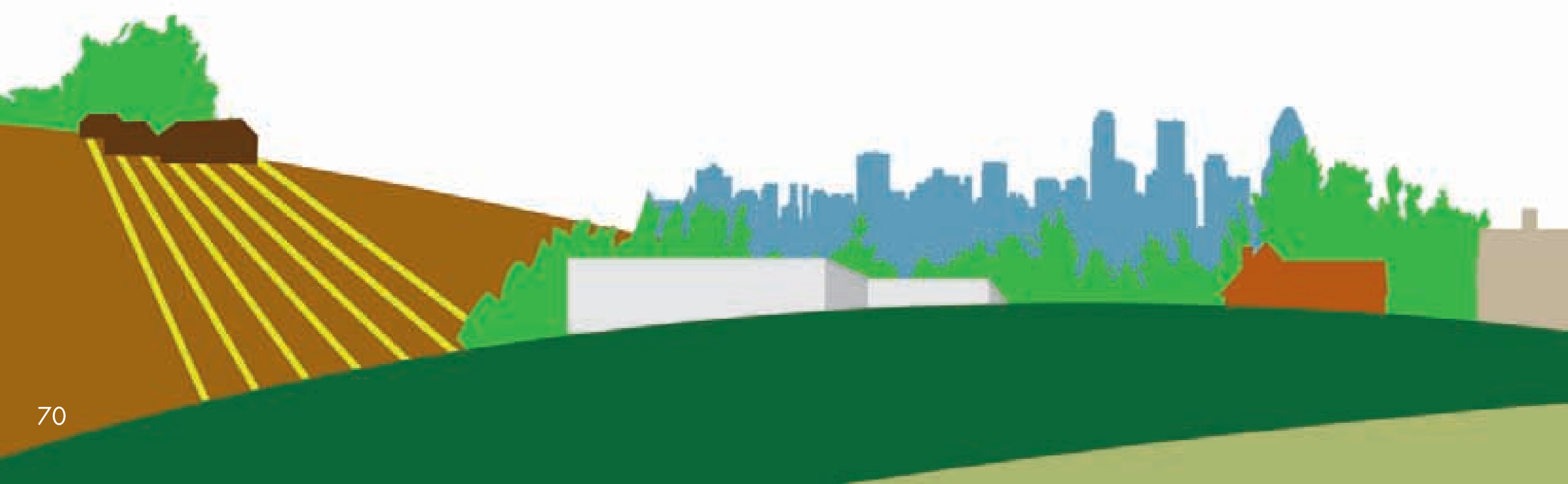
It is not unusual for a social or community enterprise to supply exempt services. This means that they cannot reclaim input VAT relating to those activities. If an organisation has some exempt activities and some taxable activities, then it may register for VAT and will be "partially exempt". In this case, it can reclaim VAT relating to the taxable activities only, unless the exempt VAT falls below de minimis limits. Partial exemption is complicated to administer.

Loan finance has no impact at all on your VAT status. This is because the receipt of the loan is not a supply. The loan interest payments are not subject to VAT.

Grant funding can have an impact on VAT. The receipt of grant funding can be either standard rated for VAT, exempt, or outside the scope. A grant will only be standard rated if it is in reality a payment for the supply of standard rated services. Some Service Level Agreements (SLAs) with Primary Care Trusts (PCTs) or local authorities are like this, and social enterprises bidding for such contracts should take care to assess the VAT status of the contract, if necessary by engaging a VAT specialist.

A grant will be exempt from VAT if it is in reality a payment for services, and those services are exempt (such as education or healthcare). Again, many SLAs are of this nature. Care is needed to check that the precise terms of any exemption are complied with.

A grant (or donation) will be outside the scope of VAT if it is not a payment for goods or services, but is simply a straight donation. Any input tax related to this grant will not be recoverable on a VAT return; however, as there is no related supply there should be very little non-recoverable input VAT. Non-recoverable input VAT should be limited to the VAT on costs related to soliciting donations or grants.



8.1.3: Capital gains tax

Organisations may be considering raising finance for the purchase of property. This may expose them to capital gains tax if the property is disposed of for more than its purchase price. Individuals benefit from a capital gains tax allowance, but incorporated entities have no such relief. It is advisable to seek advice before deciding whether to buy or rent.

8.1.4: Mutual trading status

Mutual trading refers to the business of a co-operative that only trades with its members. Any and all surpluses from the trade can be said to belong to the members, rather than to the organisation as a separate entity. The benefit is that the co-operative does not have to pay tax on trading profits, only on other income such as bank interest, because trading profits will be taxed through income tax when they are eventually distributed to the members.

You are recommended to use a legal structure designed for mutual trading, and apply for mutual tax status before you start trading. A small amount of non-member trading is allowed, but be careful to limit this. Also, make sure reserves don't get higher than needed for working capital, or you may have to make taxable dividends to reduce them.

It is important to note that it is much more difficult to achieve mutual tax status once an organisation has already started to trade on a non-mutual basis. As payments from that income must be confined to the members from whom it is derived, there can be no payment of interest on members' investments, only a dividend based on their trade.

Some trade with non-members can be managed (and taxed) with the formation of a service company (a company owned usually by the members of the co-operative and itself a member of the co-operative) through which non-member trade could be channelled. The value of this trade would have to be reasonable in the overall context of the co-operative.

The basis of members' contributions to the co-operative and the basis of distributing its surpluses need not be exactly the same but usually contributions are made in the form of charges paid under the members' agreement and payments (distributions) are in proportion to charges.

Related to this is the tax exemption for fully mutual housing co-operatives under Section 488 of the Income and Corporation Taxes Act 1988. This is similar except that a co-operative can be common ownership (no distribution of surpluses) and the exemption applies to Capital Gains Tax as well as Corporation Tax.

Although payments to co-operative members based on trade are often referred to as a dividend, they are treated very differently to investor dividends for tax purposes.

There is a scheme similar to EIS for businesses that invest in unlisted enterprises; it is called the Corporate Venturing Scheme. There is an online guide available from HMRC, or you can seek advice from an accountant.

Community Investment Tax Relief is available to people that invest in special loan funds targeted at the most deprived areas. Several CDFIs offer investments that benefit from this tax relief.

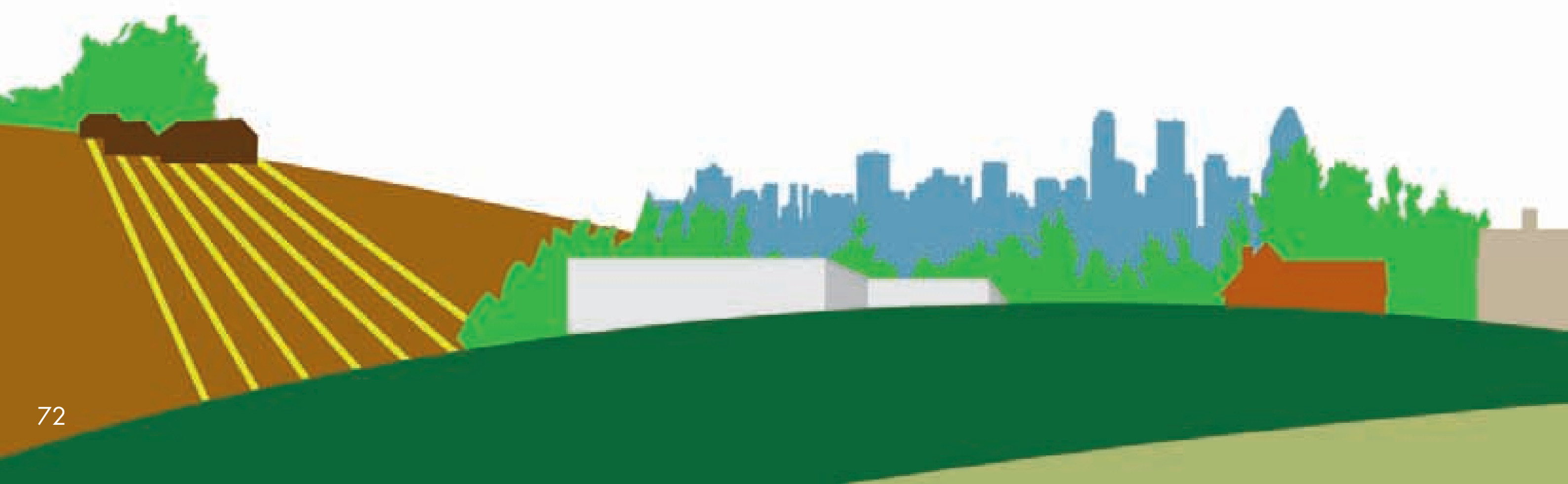
8.2: Individual taxation and deduction of tax at source

If an organisation pays interest to a company such as a bank then there is no need to deduct tax from the payment.

If a company (registered at Companies House) pays interest to individuals such as loan stock holders, then it must deduct tax at 20% from the payment. This applies even if the "payment" of interest is in the form of new loan stock. In the latter case, 80% of the interest payment is added to their loan stock balance. A company may only pay interest gross to an individual if the individual has completed form R85. If a company deducts tax from interest payments then it must account for the tax deducted to HMRC every quarter using form CT61(z). At the end of the tax year (5 April) it must also issue a tax deduction certificate to the individual, so that they can claim the tax back on their tax return.

A Co-operative Society or Community Benefit Society (formerly Industrial and Provident Society) can pay interest gross even to individual investors, unless they live overseas. Any payments to overseas investors should be accounted for using form CT61(z). Although these societies do not otherwise need to complete form CT61(z), they do need to report all payments of interest to HMRC within 3 months of their period end. If they do not, then HMRC can deny tax deduction for the interest in the society's accounts.

There is a tax credit that is available to recipients of dividends but not to people who are paid interest; that is because dividends have been paid after corporation tax. This cancels out what would otherwise be a major tax advantage to withdrawable share capital, and means that interest from withdrawable share capital is, pound for pound, not as good a return as the same payment in the form of a dividend. The exception here is low income investors who are not liable for income tax; as dividends are received net of tax, and the tax credit can't be refunded, withdrawable shares will be more tax efficient for them.



8.2.1: Enterprise Investment Scheme

The Enterprise Investment Scheme was set up by the government to encourage investment in the riskiest businesses – those that were still quite small and had not achieved listing on any stock exchange. There was no social purpose intended in it, however many Co-operatives and Community Benefit Societies carrying out share issues have found it very helpful. It is a tax incentive for investors; if they invest money for at least three years at full risk (that is, using ordinary share capital) they can claim back the income tax that they notionally paid on it (a bit like gift aid for charitable donations). 20% over three years is a significant top-up to the limited dividends that can be expected in the early stages of a small business. If the investment is lost altogether – the shares are declared null and void – there is a further 'loss relief' that can be claimed against either capital gains tax or income tax. There are also other benefits relating to capital gains and inheritance tax.

EIS is not available for all businesses: it is targeted at businesses that are involved in productive trade, and so a range of enterprises based around finance, property development, farming and forestry cannot benefit. It is available on withdrawable shares, but some problems have been encountered when rules suggest there is a 'right' to withdrawal; this constitutes protection against risk.

Before telling investors that they will be able to get it, you should seek 'advance assurance' from HMRC. They will tell you whether your organisation would be eligible. You can then tell investors that the relief is available, and three months after you have commenced trading you can request the forms that your investors will need to use to get their tax refund.

8.2.2: Stamp duty on shares

If someone buys transferable shares from an existing shareholder, they are liable to pay stamp duty. The exact level will depend on whether the transaction is electronic or on paper, but is typically 0.5% of the 'consideration' that is paid for the shares. It does not apply if the shares are transferred as a gift, without payment.

9 Next steps

This guide has provided an introduction to the diverse ways in which organisations can seek finance to develop new businesses. As outlined in chapter 2, a complete package of finance will probably involve elements from several different parts of the guide. Grants, supply chain finance, loans and equity may all have a role to play.

Having identified which options are going to be most effective in taking your business idea forward, you will need to adopt an action plan to ensure that the different parts of your finance package come to fruition at the same time. Plot timelines for each; some grants will take a long time to prepare, and loan applications and share issues may need detailed planning and preparation. Some options may even require rules changes at a general meeting, or the formation of completely new legal structures.

Plan your actions so that they all come to fruition more or less together, and those that can be put in place more quickly are implemented in the light of earlier developments.

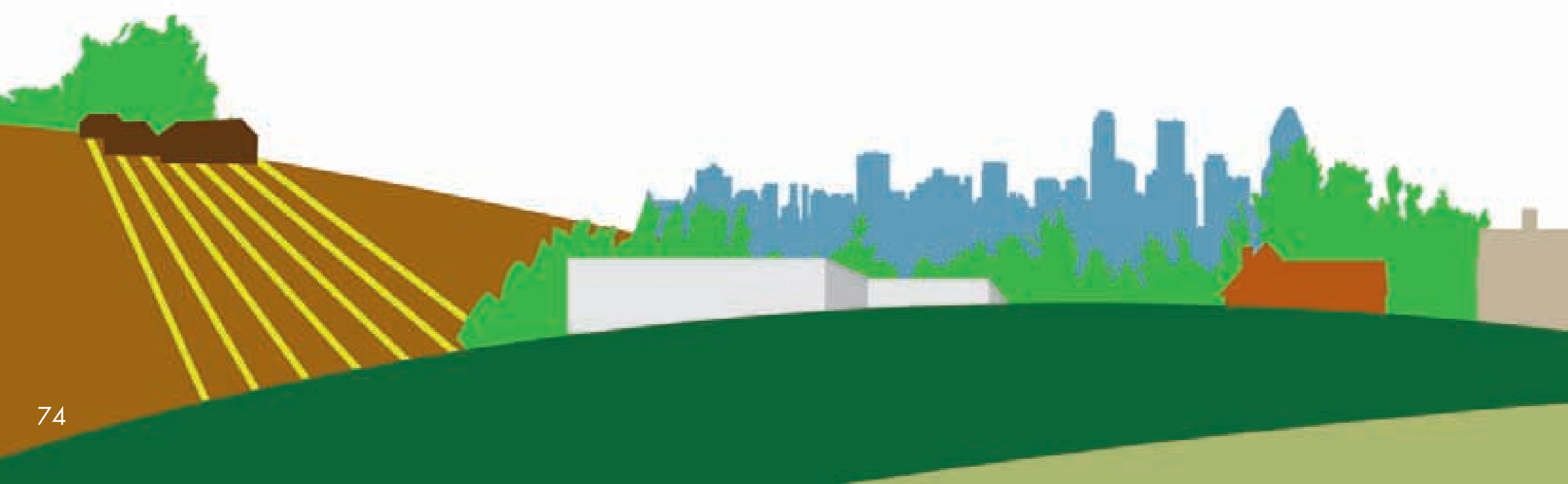
The action plan should be widely understood and supported within your organisation, so that everyone is committed to the obligations that funders, lenders and investors will place you under; and everyone knows what their role in the process is.

Once the finance comes together, and your business plan comes into effect, you can begin changing the world. Or at least, your bit of it.

This edition of the guide has been published using funding from the Big Lottery Fund as part of the 'Making Local Food Work' project. The main aim of this project is to reconnect people and land and promote access to fresh, healthy, local food with a clear provenance.

The project uses the social and community enterprise sector to develop collaborative responses to meeting the needs of all sections of the community in regard to access to local food.

This project will run until 2012 and comprises six delivery strands and four supporting themes, each seeking to refine and replicate a form of community enterprise model to reconnect food producers and consumers.



Appendix 1

Summary table of legal forms

	Issue shares?	Approval needed for larger share issues?	Investor dividends payable?	Capable of mutual trading status?	Access lottery funding?
Company limited by guarantee (inc. CIC)	No	-	-	Yes, but not a CIC	Yes
Company limited by shares	Yes	Yes	Yes	Yes	Not usually
CIC limited by shares	Yes	Yes	Yes, but capped	No	Yes
Co-operative Society	Yes	No, if using withdrawable shares	Yes, if necessary to finance a trade	Yes	Common ownership co-operatives only
Community Benefit Society	Yes	No	Yes, if necessary to benefit the community	No	Yes
Limited Liability Partnership	No	-	-	Yes	No
Charitable Incorporated Organisation*	No	-	-	No	Yes

* The Charitable Incorporated Organisation form is not likely to be available as a legal form until late 2011.

Appendix 2

Sources of finance

Community Development Finance Associations

Triodos Bank
Brunel House
11 The Promenade
Bristol
BS8 3NN
0117 973 9339
www.triodos.co.uk

Ecology Building Society
7 Belton Road
Silsden
Keighley
BD20 0EE
0845 674 5566
www.ecology.co.uk

Co-operative and Community Finance
Brunswick Court
Brunswick Square
Bristol
BS2 8PE
01179 166750
www.co-opandcommunityfinance.coop

The Co-operative Bank
P.O. Box 101
1 Balloon Street
Manchester
M60 4EP
www.co-operativebank.co.uk

Specialist teams

Charities:
020 7977 2121
charities@co-operativebank.co.uk

Social housing:
01782 408507
martin.latham@britannia.co.uk

Unity Trust Bank
Nine Brindley Place
Birmingham
B1 2HB
0845 140 1000
www.unity.co.uk

Charity Bank
194 High Street
Tonbridge
Kent
TN9 1BE
01732 744 040
www.charitybank.org

Radical Routes
16 Sholebroke Avenue
Leeds
LS7 3HB
0845 330 4510
www.radicalroutes.org.uk

Rathbone Greenbank
10 Queen Square
Bristol
BS1 4NT
0117 930 3000
www.rathbonegreenbank.com

Bridges Ventures
1 Craven Hill
London
W2 3EN
020 7262 5566
www.bridgesventures.com

Big Issue Invest
1-5 Wandsworth Road
London
SW8 2LN
0207 526 3434
www.bigissueinvest.com

Baxi Partnership
Evans Business Centre
Pitreavie Business Park
Dunfermline
Fife
KY11 8UU
01383 749672
www.baxipartnership.co.uk

Venturesome
Charities Aid Foundation
St Andrew's House
18-20 St Andrew Street
London
EC4A 3AY
03000 123 300
www.cafonline.org

CAN Invest
CAN Mezzanine
49-51 East Road
London
N1 6AH
020 7922 7757
www.can-online.org.uk

Adventure Capital Fund
5th Floor
6 St Andrew Street
London
EC4 3AE
020 7842 7760
www.adventurecapitalfund.org.uk

Appendix 3

Sources of further guidance and advice

National Support Bodies

Co-operatives UK
Holyoake House
Hanover Street
Manchester
M60 0AS
0161 246 2900
www.uk.coop

Social Enterprise Coalition
49-51 East Road
London
N1 6AH
020 7793 232
www.socialenterprise.org.uk

The Co-operative Enterprise Hub
0161 246 3020
www.co-operative.coop/enterprisehub

Energy 4 All
Unit 33
Trinity Enterprise Centre
Furness Business Park
Barrow-in-Furness
LA14 2PN
01229 821028
www.energy4all.co.uk

UKSIF-the Sustainable Investment and Finance Association
Holywell Centre
1 Phipp Street
London
EC2A 4PS
020 7749 9950
www.uksif.org

CDFA
Room 101
Hatton Square Business Centre
16/16a Baldwins Gardens
London
EC1N 7RJ
020 7430 0222
www.cdfa.org.uk

Social Finance
42 Portland Place
London
W1B 1NB
020 7182 7878
info@socialfinance.org.uk

Co-operative and Social Enterprise Development Bodies

Wales Co-operative Development & Training Centre Limited
Llandaff Court
Fairwater Road
Cardiff
South Glamorgan
CF5 2XP
walescoop@walescoop.com
02920 554 955

Hackney Co-operative Developments CIC
62 Beechwood Road
London
E8 3DY
info@hced.co.uk
020 7254 4829

Co-operative Futures City Works
Alfred Street
Gloucester
Gloucestershire
GL1 4DF
info@co-operativefutures.coop
01452 543030

Avon CDA BRAVE Ltd
The Coach House
2 Upper York Street
Bristol
BS2 8QN
info@avoncda.coop
0117 989 2536

Coventry & Warwickshire Co-operative Development Agency Ltd
Doe Bank Building
Doe Bank Lane
Coventry
West Midlands
CV1 3AR
info@cwcda.co.uk
024 7663 3911

Greenwich Co-operative Development Agency Ltd
Unit 6, Greenwich Centre Business Park
53 Norman Road
Greenwich
London
SE10 9QF
admin@gcda.org.uk
020 8269 4880

Harlow CDA Ltd
2 Wych Elm
Harlow
Essex
CM20 1QP
info@harlowcda.co.uk
0203 239 4090

Humberside Co-operative Development Agency Limited
90 Marlborough Avenue
Hull
East Yorkshire
HU5 3JT
jon@humbersidecda.info
01482 449 877

LCCDA Management Co-operative Ltd
New House
94 New Walk
Leicester
Leicestershire
LE1 7EA
enquiries@case-da.co.uk
0116 222 5010

Northamptonshire CDA
214A Kettering Road
Northampton
Northamptonshire
NN1 4BN
sarah@enterprise-solutions.org.uk
0845 456 8281

Southampton Area CDA
135 St Mary's Street
Southampton
Hampshire
SO14 1NX
sacda@can.coop
0845 3733616

Tower Hamlets CDA
Unit 6, Business Development Centre
7-15 Greatorex Street
London
E1 5NF
info@co-operation.coop
020 7247 1056

Social Enterprise London CIC
3rd Floor
Downstream Building
1 London Bridge
London
SE1 9BG
info@sel.org.uk
020 7022 1920

Sheffield Co-operative Development Group
Aizlewoods Mill
Nursery Street
Sheffield
South Yorkshire
S3 8GG
alan@scdg.org
0114 282 3100

Community Empowerment Limited
90 Locksway Road
Southsea
Hampshire
PO4 8JP
ceo@empower.coop
01329 223 043

Lincolnshire CDA
Commerce House
Outer Circle Road
Lincoln
Lincolnshire
LN2 4HY
ccooke@lincolnshire.coop
01522 845005

Co-operative Assistance Network
The Coach House
2 Upper York Street
Bristol
BS2 8QN
services@can.coop
0845 373 3616

The Guild
St. John's House
25 St. John Maddermarket
Norwich
Norfolk
NR2 1DN
services@the-guild.co.uk
01603 615200

Community Enterprise Unit
Garden Floor
Suite 1
11-15 Dix's Field
Exeter
Devon
EX1 1QA
ceu@ceultd.co.uk
01392 666281

Economic Partnerships Limited
The Old Post Office
63 Saville Street
North Shields
Tyne and Wear
NE30 1AY
info@economicpartnerships.com

Co-operative and Mutual Solutions
7 Cecil Street
Lytham
Lancashire
FY8 5NN
info@cms.coop
07967 815321

Co-operative Business Consultants
35 Heaton Grove
Bradford
West Yorkshire
BD9 4DZ
info@cbc.coop
0845 456 0238

Mutual Advantage Partnership
24 Blashford Street
Hither Green
London
SE13 6UA
info@mutual-advantage.co.uk
020 8698 0712

Social Economy and Co-operative Development Cornwall
3 Trenhaile Terrace
Malpas
Cornwall
TR1 1SL
info@cornwall-switch.org
01872 262 259

Social Enterprise and Co-operative Development Limited
Wallsend House
The Old Rectory
Church Lane
Bowness-On-Solway
Cumbria
CA7 5AF
info@secod.coop
01697 351010

Co-operative Development Scotland
Spectrum House
1a North Avenue
Clydebank Business Park
Clydebank
G81 2DR
carol.smith@cdscotland.co.uk
0141 951 3055

Somerset Co-operative Services CIC
12 North Street
Stoke-sub-Hamdon
Somerset
TA14 6QP
services@somerset.coop
0845 458 1473

Natty Platy
174 Manor Farm Road
Southampton
Hampshire
SO18 1NX
cris@nattyplaty.com
07903 918 798

Ex-cell Solutions Ltd
The Wesley
Enterprise Centre
Royce Road
Hulme
Manchester
Greater Manchester
M15 5BP
info@ex-cell.org.uk
0161 232 1424

Co-operative Finance Consultants and Specialist Accountants

Baker Brown Associates
31 Ambrose Street
Bristol
BS8 4RJ
0117 925 0824
www.bakerbrown.co.uk

Wessex Community Assets
Great Bow Wharf
Bow Street
Langport
TA10 9PN
07795 528801
www.wessexca.co.uk

Co-opportunity
Unit 59
Easton Business Centre
Felix Road
Easton
Bristol
BS5 0HE
0117 941 5345
www.coopportunity.org.uk

Slade and Cooper
6 Mount Street
Manchester
M2 5NS
0161 831 0100
www.sladecooper.co.uk

Specialist Independent Financial Advisors and Funds

The Ethical Investment Association
Holywell Centre
Phipp Street
London
EC2A 4PS
0207 749 9950
www.ethicalinvestment.org.uk

Clearly So
4th Floor
20 Old Street
London
EC1V 9AB
020 7490 9520
www.clearlyso.com

Resonance
42 St Thomas Road
Launceston
PL15 8BX
0845 0043432
www.resonance.ltd.uk

Equity Plus
P.O. Box 163
Ware
Herts
SG12 0ZN
0845 527 9227
www.equityplus.org.uk

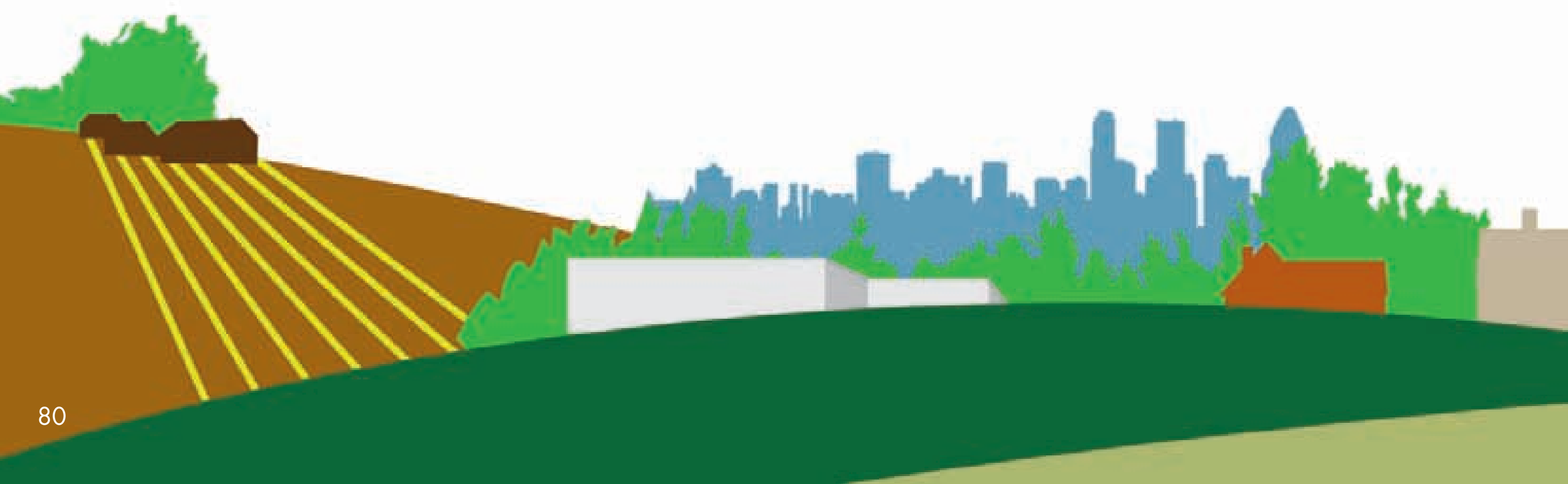
Investing for Good
40, Stockwell Street
London
SE10 8EY
020 7060 1175
www.investingforgood.co.uk

Books and Online Resources

Simply Legal
www.uk.coop/simplylegal

Community Shares Practitioner's Guide
www.communityshares.org.uk/resources

Co-operative Capital
www.somerset.coop/sites/default/files/Co-operative_Capital.pdf



Appendix 4

Forms and agreements

Model loan agreement

This agreement is made on the ……………………… day of ………………… 20…………

Between:

(1) Name: ……………………………………………………………………… ["the Borrower"]
(full registered name of corporate body i.e. company or society including Limited)

Address: ……………………………………………………………………………………

Registration number: ………………………………………………………………………

(2) Name: ……………………………………………………………………… ["the Lender"]

Address: ……………………………………………………………………………………

NOTE: if Lender is also a corporate body i.e. company or society the full registered name should be inserted along with the register number.

It is agreed as follows:

The loan

The Lender has agreed to advance to the Borrower the sum of £……………… subject to the following terms.

Agreed terms

Definitions and Interpretation
The definitions and rules of interpretation in this clause apply in this agreement.

Business Day: a day (other than a Saturday or a Sunday) on which commercial banks are open for general business in London and deposits are dealt with on the London Interbank Market.

Facility: the term loan facility made available under this agreement.

Indebtedness: any obligation to pay or repay money, present or future, whether actual or contingent, sole or joint.

Loan: the total principal amount of the loan outstanding under this agreement.

Sterling and £: the lawful currency of the United Kingdom.

Clause, schedule and paragraph headings do not affect the interpretation of this agreement.

A reference to this agreement (or any provision of it) or any other document shall be construed as a reference to this agreement, that provision or that document as it is in force for the time being and as amended, varied or supplemented from time to time in accordance with its terms, or with the agreement of the relevant parties.

A reference to a person shall include a reference to an individual, firm, company, corporation, unincorporated body of persons, or any state or any agency of that person.

A reference to a statute, statutory provision or subordinate legislation is a reference to it as it is in force for the time being, taking account of any amendment

or extension, or re-enactment and includes any former statute, statutory provision or subordinate legislation which it amends or re-enacts.

A reference to writing or written includes faxes but not e-mail.

A reference to continuing in relation to an Event of Default means an Event of Default which has not been remedied or waived.

The Facility

The Lender grants to the Borrower an unsecured sterling term loan facility of a total principal amount not exceeding £______ on the terms, and subject to the conditions, of this agreement.

Purpose

The Borrower shall use all money borrowed under this agreement to pay for _________

____

The Lender is not obliged to monitor or verify how any amount advanced under this agreement is used.

Drawing

The Borrower may draw the Loan in a single amount on or before______. To do this, the Borrower shall give the Lender at least 24 hours' prior notice of the date on which the Borrower wants to draw the Loan.

Interest

The Borrower shall pay interest on the Loan at the annual rate of ________%.

If the Borrower fails to make the payment due under this agreement on the due date for payment, interest on the unpaid amount shall accrue daily, from the date of non-payment to the date of actual payment, at 1% above the rate specified in clause 1.10.

Costs

The Borrower shall pay, on demand and on a full indemnity basis, all costs and expenses (together with any value added tax on them) that the Lender incurs in connection with the negotiation and preparation, amendment, extension, alteration, and enforcement of the Loan and/or this agreement.

Repayment

The Borrower shall repay the Loan and all accrued interest in monthly instalments.

Payments

The payment made by the Borrower under this agreement shall be in Sterling:

in full, without any deduction, set-off or counterclaim; and

in immediately available cleared funds on the due date to the account that the Lender may specify to the Borrower.

Event of Default

At any time after an Event of Default has occurred and is continuing, the Lender may give notice to the Borrower, stating that the Loan (and all accrued interest and all other amounts accrued or outstanding under this agreement) is immediately due and payable or payable on demand. On receiving this notice, the Borrower shall immediately repay the Loan, the accrued interest and all those other amounts.

Calculations, accounts and certificates

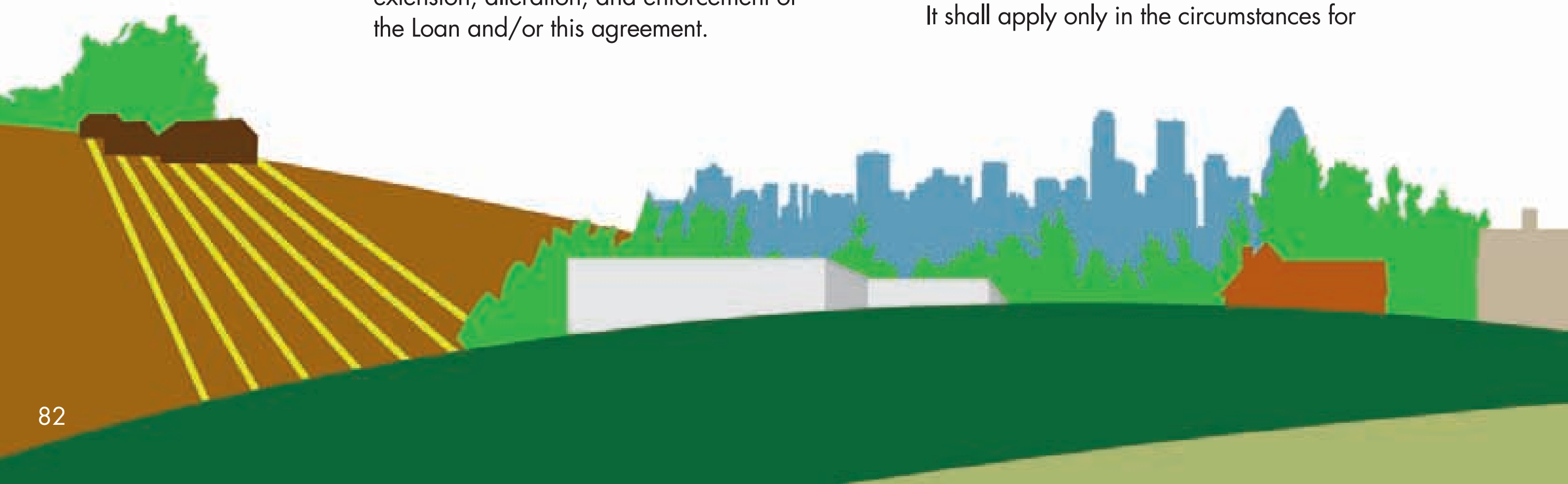
The Lender shall maintain accounts evidencing the amount the Borrower owes it, in accordance with its usual practice. Entries in those accounts shall be prima facie evidence of the existence and amount of the Borrower's obligations as recorded in them.

If the Lender issues any certificate, determination or notification of a rate or any amount payable under this agreement, it shall be conclusive (in the absence of manifest error) evidence of the matter to which it relates and shall contain reasonable details of the basis of determination.

Remedies, waivers, amendments and consents

Any amendment to this agreement shall be in writing and signed by, or on behalf of, each party.

Any waiver of any right or consent given under this agreement is only effective if it is in writing and signed by the waiving or consenting party. It shall apply only in the circumstances for



which it is given and shall not prevent the party giving it from subsequently relying on the relevant provision.

No delay or failure to exercise any right under this agreement shall operate as a waiver of that right.

No single or partial exercise of any right under this agreement shall prevent any further exercise of that right (or any other right under this agreement).

Rights and remedies under this agreement are cumulative and do not exclude any other rights or remedies provided by law or otherwise.

Severance

The invalidity, unenforceability or illegality of any provision (or part of a provision) of this agreement under the laws of any jurisdiction shall not affect the validity, enforceability or legality of the other provisions.

If any invalid, unenforceable or illegal provision would be valid, enforceable and legal if some part of it were deleted, the provision shall apply with whatever modification as is necessary to give effect to the commercial intention of the parties.

Counterparts

This agreement may be executed and delivered in any number of counterparts, each of which is an original and which, together, have the same effect as if each party had signed the same document.

Third party rights

A person who is not a party to this agreement cannot enforce, or enjoy the benefit of, any term of this agreement under the Contracts (Rights of Third Parties) Act 1999.

Notices

Each notice, request, demand or other communication under this agreement shall be: in writing, delivered personally or sent by pre-paid first-class letter or fax (confirmed by letter).

Governing law and jurisdiction

This agreement and any dispute or claim arising out of or in connection with it or its subject matter or formation (including non-contractual disputes or claims) shall be governed by, and construed in accordance with, the law of England and Wales.

The parties to this agreement irrevocably agree that the courts of England and Wales shall have exclusive jurisdiction to settle any dispute or claim that arises out of or in connection with this agreement or its subject matter or formation (including non-contractual disputes or claims).

This agreement has been entered into on the date stated at the beginning of it.

Signed by

for and on behalf of the Lender.

....

for and on behalf of the Borrower.

....

Model loan stock application

Application for loan stock in

Name ………………………………………………………………………… [the Co-operative]
(full registered named of corporate body i.e. company or society including Limited)

Registered office address …………………………………………………………………………

Registration number: …………………………………………………………………………

I …………………………………………………………………………………………… (name)

of ………………………………………………………………………………………… (address)
wish to apply for loan stock in the above co-operative on the basis of the attached conditions.

Amount applied for £ ………………………………………….

I have read the conditions attached and I accept them.

……………………………………………………… (signed) ……………………………… (date)

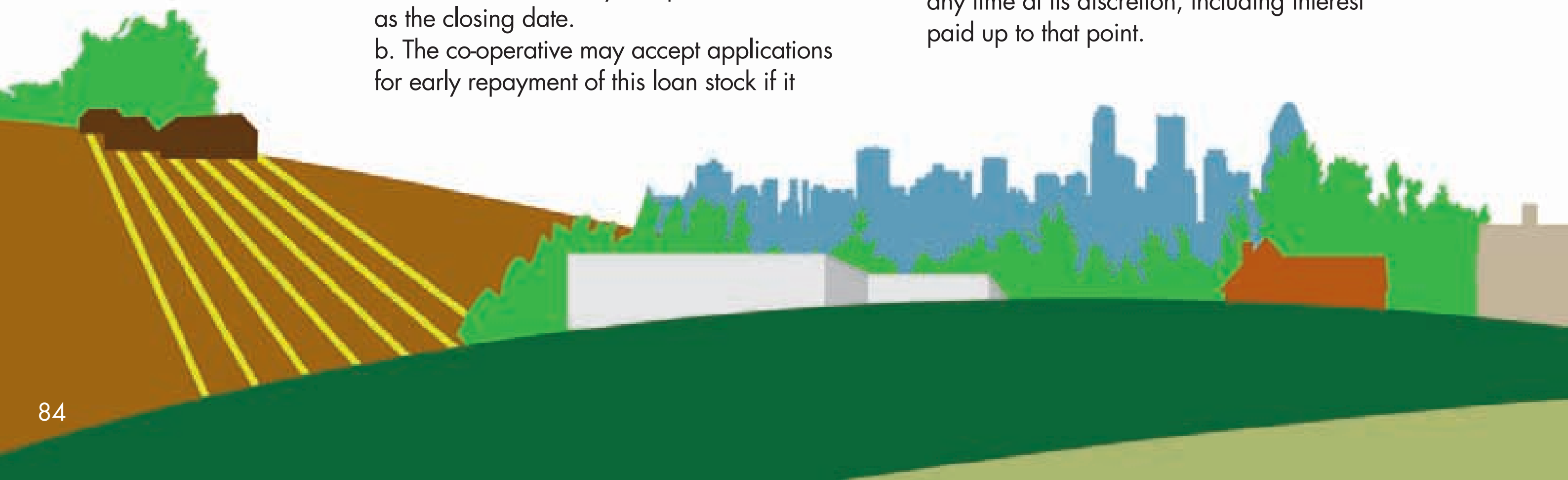
Conditions

1. Interest

a. Interest shall be paid at the rate specified above on each full £100 of loan stock held, on the 31st December of each year, or upon the withdrawal of loan stock.
b. In the event of the loan stock having been invested for less than the full year, interest shall be paid pro rata.
c. No amount less than £1 shall be credited.
d. Loan stock certificates for interest carrying the same conditions as the principal shall be despatched no more than four weeks after the interest becomes due.

2. Repayment

a. This loan stock will be repaid in full on the 31st December of the year specified above as the closing date.
b. The co-operative may accept applications for early repayment of this loan stock if it considers that there are sufficient funds available, or if a replacement investment can be arranged.
i. A written notice stating the amount to be repaid, must be sent to the co-operative together with the loan stock certificate.
ii. Repayment will normally be made within the following periods of time after receipt of notice: up to £500, 1 month; up to £2000, 2 months; up to £5000, 3 month; or over £5000, 4 months.
iii. Where part of the loan stock only is repaid, a new certificate for the outstanding amount shall be issued to the holder.
iv. Applications for repayment shall be dealt with strictly in the order of the dates they are due according to ii above.
c. The co-operative may repay loan stock at any time at its discretion, including interest paid up to that point.



3. Repayment on default

a. The co-operative shall repay this loan stock in full immediately if the co-operative:
i. is in breach of these conditions; or
ii. is overdue on any payment by 21 days or more; or
iii. passes a resolution for winding up, or goes into liquidation, or has an administrative receiver appointed over any of its assets, or has an administration order made against it, or an effective instrument of dissolution is made by the members of the co-operative.

4. General

a. These conditions shall not give the lender(s) any rights to attend meetings or participate in any way in the management of the co-operative other than those she/he might have as members.
b. These conditions shall not in any way be affected by the Lender becoming or ceasing to be a member of the co-operative.
c. These conditions may be varied at any time by decision of the co-operative.
d. Loan stock is non-transferable.

Model loan stock certificate

………

(full registered named of corporate body i.e. company or society including Limited)

Certificate no……………………………… **Amount of Loan Stock £** ……………………………

This is to certify that ………………………………………………………………………… (name) of

………………………………………………………(address) is the holder of £ ………………

fully paid of loan stock in the above co-operative issued subject to the conditions set out overleaf.

Signed for and on behalf of the co-operative

……………………………………………… (Director)

……………………………………………… (Director/secretary)

NOTE: the conditions on the loan stock application form should be repeated on the certificate.

Corporate application for withdrawable shares issued by

Name .... [the Co-operative]
(full registered named of corporate body i.e. company or society including Limited)

Register number..

To become a corporate member requires a minimum of .... shares. Each share costs £1. Each shareholding member has one vote, regardless of the size of their shareholding. The maximum permissible shareholding is £20,000 except for other Co-operative and Community Benefit Societies.

Applications must be received at the office of the Co-operative before .... 20......

I/We wish to become a member of .... Limited [the Co-operative] in accordance with the rules, & apply for: shares, and enclose payment for that amount (cheques payable to .... Limited [the Co-operative]).

Full Official Name ....

Address for correspondence ....

Registration number .... Contact name ....

Telephone .... Email...

Agreement
We agree to be bound by the Terms and Conditions included in the attached prospectus and the Rules of the Co-operative.

We understand that the Co-operative's Board may reject our application and does not have to tell us why it has been rejected.

Data protection & money laundering
The data provided by you on this form will be stored within a computerised database. This data will only be used for the Co-operative's purposes and will not be disclosed to a third party.

It is a term of the offer that to ensure compliance with the Money Laundering Regulations 2003, the Co-operative may at its absolute discretion require verification of identity from any person/organisation seeking to invest.

Signed as a deed Director Director / secretary

Signature ....

Name ....

for and on behalf of ....

Date ....

Application for withdrawable shares issued by

Name .... [the Co-operative]
(full registered named of corporate body i.e. company or society including Limited)

Register number...

This form should only be completed if you wish to nominate a person to receive your shares on your death. You can nominate a person to whom you wish your shares to be transferred on your death. We will respect those wishes (so far as the law and our Rules permit).

If you are a joint holder and you do not wish your holding to pass to the other joint shareholder(s) then you must complete this form. You may nominate a person to whom you wish your joint shareholding to be transferred on your death.

Name ....

Address ....

Phone .... Email ....

I understand that it may not be possible for the Co-operative to action this request and I and my heirs will not hold the Co-operative responsible for its actions.

I understand that these instructions can only be revoked or amended by my giving clear written instructions to the Secretary of the Co-operative at the registered office.

I understand that trustees will need to be appointed if my nominee is under 16 years of age.

Signed as a deed

Signature .... Date ....

Witness signature ....

Name and address of witness ....

....

Terms and Conditions for applying for Withdrawable Shares

You cannot withdraw your application for shares after we receive your application form. We do not have to accept your application for shares. We may decide not to issue shares to you. Or we may decide to issue to you fewer shares than you apply for. We do not have to give any reason for our decision.

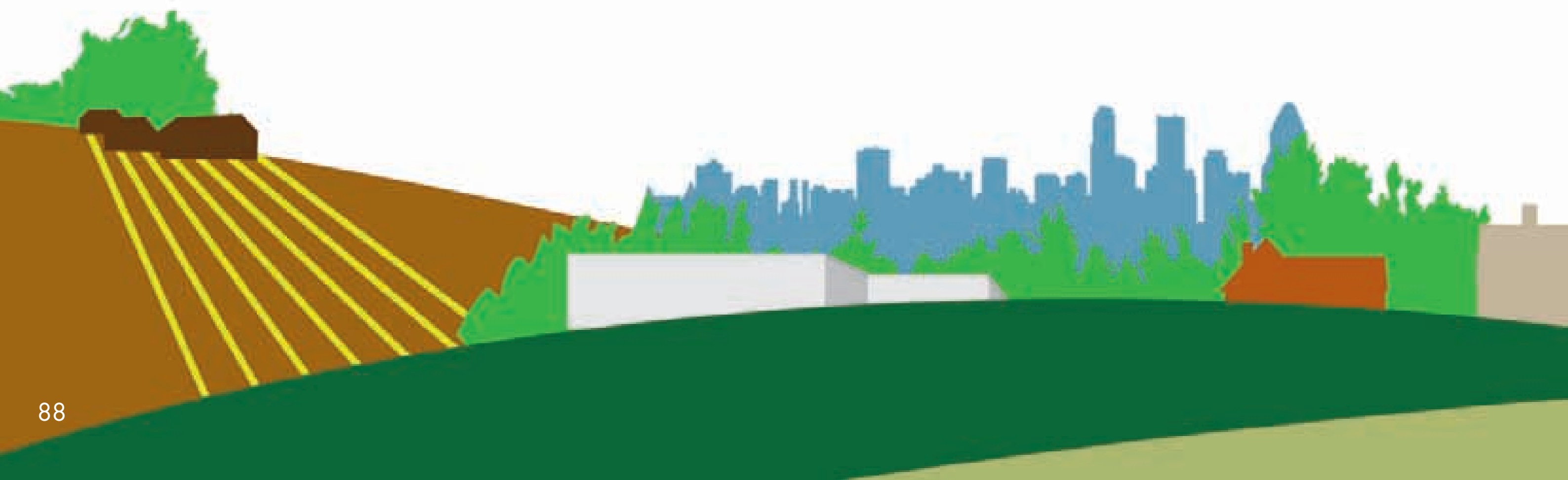
Your application must be considered for approval at the next convenient Board of Directors meeting and these normally take place four times per year, and therefore you should not expect an immediate response.

We will acknowledge receipt of your cheque and application. We may cash your cheque as soon as we receive it. But until we issue shares to you, we will keep your money in a separate account. We will hold that money on trust for you until we issue shares to you.

We will return your cheque to you (within seven days of the Board of Directors meeting at which we consider your application) if we decide not to issue shares to you. If we decide to issue to you, fewer shares than you apply for, we will return the balance to you (within seven days of that Board of Directors meeting).

The money will belong to us (and we no longer hold it on trust for you) as soon as we issue shares to you (to the extent that we take it as payment for shares). We will not pay you interest on any money we return to you.

The law of England applies to these terms. The courts of England and Wales have non-exclusive jurisdiction. You will be bound by our rules (as may be amended from time to time) if we issue shares to you.



Sophisticated Investor Self-Certification Form

I declare that I am a sophisticated investor for the purposes of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

I understand that this means:
(a) I can receive financial promotions that may not have been approved by a person authorised by the Financial Services Authority;
(b) the content of such financial promotions may not conform to rules issued by the Financial Services Authority;
(c) by signing this statement I may lose significant rights;
(d) I may have no right to complain to either of the following:
 (i) the Financial Services Authority; or
 (ii) the Financial Ombudsman Scheme;
(e) I may have no right to seek compensation from the Financial Services Compensation Scheme.

I am a certified sophisticated investor because at least one of the following applies –

(a) have been a member of a business angels network for at least six months; or
(b) have made at least one investment in an unlisted security in the previous two years; or
(c) have worked in a professional capacity in the provision of finance to small- or medium-sized businesses in the last two years or in the provision of private equity; or
(d) be or have been within the last two years a director of a company with a turnover of at least £1m.

I accept that I can lose my property and other assets from making investment decisions based on financial promotions.

I am aware that it is open to me to seek advice from someone who specialises in advising on investments.

Signature .... Date ....

Please print name ....

Appendix 5

Glossary

Allotment Shares can be allotted to an investor without funds having actually been received; the shares are 'paid up' when the money has been handed over.

The Alternative Investment Market
The part of the London Stock Exchange for small companies or ones too young to meet the requirements for full quotation, often abbreviated to AIM.

Authorised share capital
Businesses issuing transferable shares can be authorised by its members to issue a limited number of shares, to avoid dilution. It is not compelled to issue all of them and many companies like to keep some in reserve for rights issues, employee incentives etc.

Base Rate The UK's core interest rate and the rate at which the Bank of England deals with the market. It is set at monthly meetings of the Monetary Policy Committee.

Bonds An agreement to repay a sum invested, with interest (usually at a fixed rate). Normally the investor will expect to get the initial investment back on a predetermined date.

Class Shares Shares can be issued in different classes. They may have different conditions in terms of their redemption (see redeemable shares), the payment of dividend or the degree of risk (see preference shares) or may have special or limited voting rights.

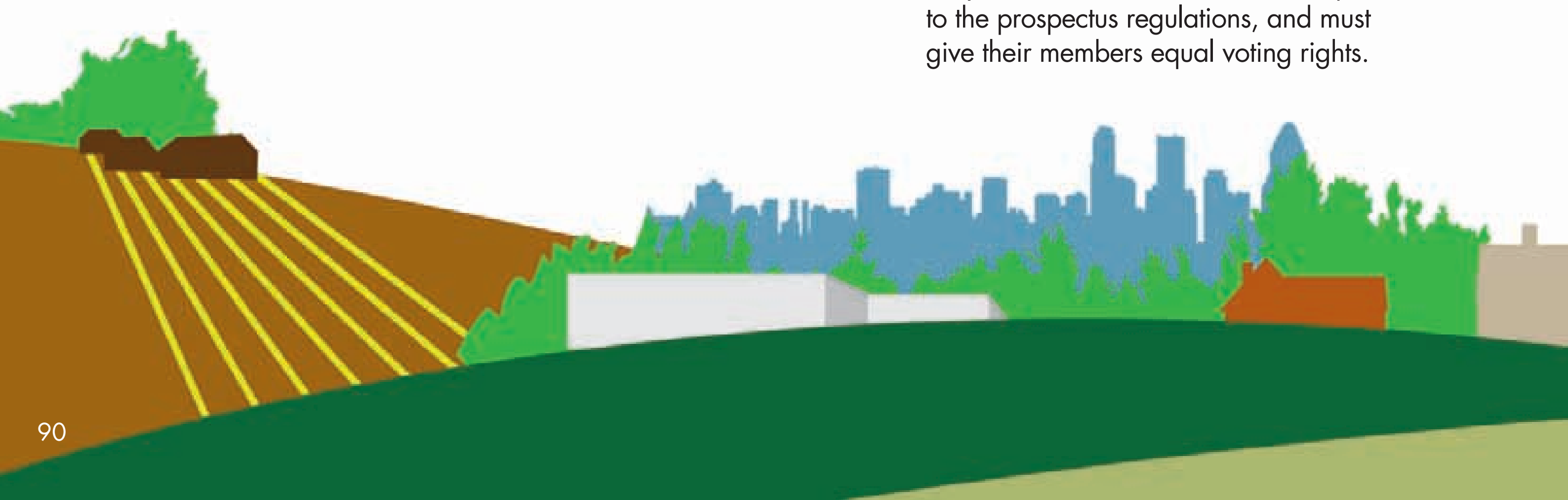
Community Interest Company (CIC)
This is a normal limited company (registered at Companies House) but is subject to an "asset lock" and special rules about dividends. Can be limited by guarantee, by shares or be a Plc. If it issues shares, it is subject to strict limits on the amount of profits it can pay in dividends, and the level of the dividends themselves.

Community Investment Tax Relief (CITR) A tax relief worth slightly less than the Enterprise Investment Scheme for people investing in funds that themselves lend to or invest in businesses meeting very specific criteria of deprivation, mainly according to geography and business sector.

Company limited by guarantee
A company formed with no share capital: the only thing backing it is the 'guarantee' of its members. Usually used as a vehicle for not-for-profit activities.

Convertible preference shares
May be changed after a fixed term into ordinary shares.

Co-operative and Community Benefit Society A form of incorporated body administered by the FSA, rather than Companies House. Until 2011 they were known as Industrial and Provident Societies. They must be either for the benefit of the community, in which case they should give a minimal return on investment, or a co-operative, in which case they must carry out a bone fide trade. They benefit from some limited exceptions to the prospectus regulations, and must give their members equal voting rights.



Cumulative preference shares Accumulate dividend arrears and carry them forward, but non-cumulative shares receive dividends only if the company pays them.

Debenture Interest bearing stock, usually issued by private companies to raise money in return for a rate of interest to the lender. The stock may be secured against the assets of the company, and may be transferred to others.

Depreciation A provision made in the accounts for the fall in the value of assets held by a business. Depreciation only impacts on cash flow at the point when an asset is sold or replaced, but an estimate based on the durability of the asset makes profit and loss statements more realistic.

Dilution If a company issues shares to more people, existing shareholders may see their stake 'diluted' because dividends are more widely spread. For this reason, issuing more shares may require a motion at a general meeting, giving shareholders the chance to object; the new shares may also be issued at a higher price, so that existing shareholders get a disproportionate return.

Dividend The payment an organisation makes to shareholders from available profit. UK companies will usually pay any annual dividend in two parts – an interim and a final dividend. Final dividends require approval at AGM to become legally binding on the company but interim dividends only need to be declared by the governing body. Withdrawable shares are said to pay interest, rather than dividend; though it can behave in very similar ways.

Not to be confused with co-operative dividends, which are a member's share based on their relationship with the co-op.

Dividend cover The number of times a company's net earnings cover its dividend.

Dividend Yield The percentage return on your investment in a share.

Earning per share (EPS) Profits made by a company and attributable to the ordinary shareholders averaged over the number of ordinary shares in existence.

Enterprise Investment Scheme (EIS) A tax relief for people investing directly in productive small businesses; it provides in effect roughly an extra 6% dividend for the first three years, provided you leave your investment there that long.

Gearing The ratio of a company's debt to its assets. A highly geared company has borrowed heavily and may be considered risky; a lightly geared company may be spreading its dividends among too many shareholders, leading to dilution.

Gross The total before any costs or deductions.

High Net Worth Someone who has certified themselves as having a great deal of money, according to a specific definition. Any company can offer shares to a High Net Worth individual without an authorised prospectus.

Indivisible reserve Reserves that are indivisible cannot be distributed, under any form, both during the life of the co-operative and during its dissolution.

Industrial and Provident Society (IPS) See Co-operative and Community Benefit Society.

Internal rate of return A measure used by economists to compare different investments. It can allow for different levels of return each year and treats early returns as being more valuable than later ones. It is sometimes known as the 'effective interest rate'.

Issued share capital The shares the company has actually sold as opposed to the authorized share capital that it is allowed to sell.

Loan stock Essentially the same as a debenture or a bond. Normally has a 'closing date' on which investment will be repaid, with repayments before that date being at the discretion of the governing body.

Matched bargain A way of selling transferable shares that are not listed on an exchange; a broker will put shareholders wishing to sell in touch with shareholders wishing to buy and will help determine a fair price.

Members The shareholders of a company or society, or the guarantors in a Company limited by guarantee.

Net The value after costs and deductions are taken into account.

Nominal value/ face value/ par value The stated value of the share as frequently printed on it. The market value of a share is that derived from freely trading. The Market Value of a company is obtained by multiplying the price of the shares by the number of shares in existence.

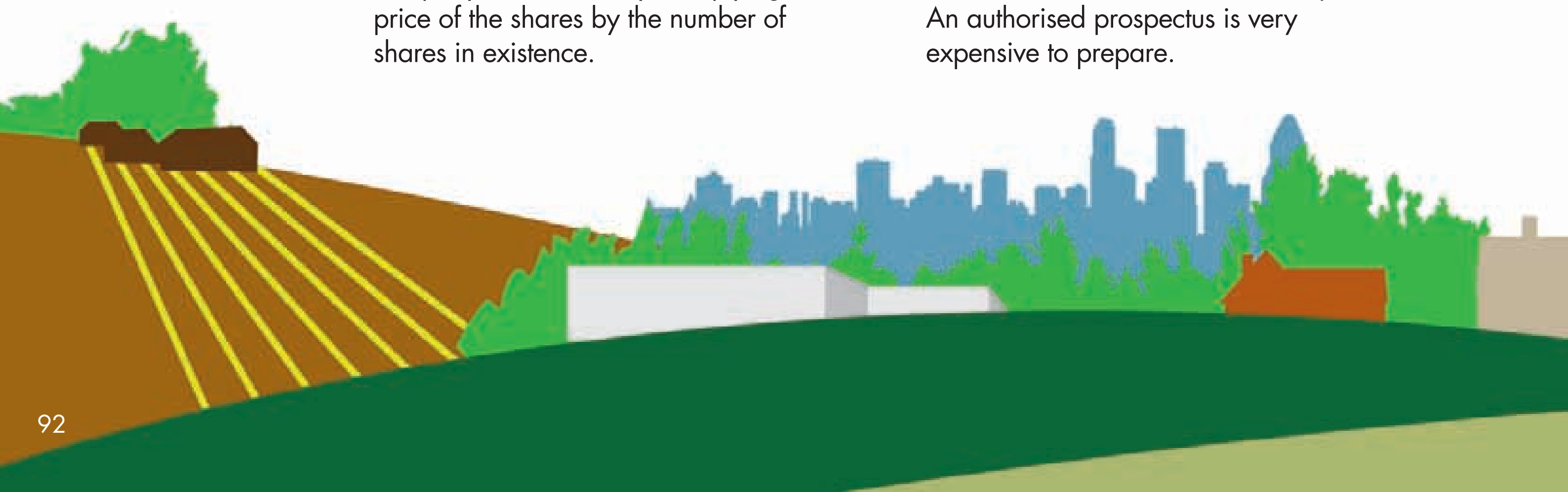
Non-user members In a Co-operative Society, non-user members are shareholders that do not make use of the services of the co-operative (in a worker co-operative, workers are considered users as the main service provided is the provision of employment) – they are instead just investors or supporters. They can hold shares, but must have strict limits on their voting rights.

Ordinary Shares Having a 'full risk' stake in a company. The shareholders are entitled to vote at annual general meetings, gives the investor a share in the company's dividend, and a stake in the assets. The shareholder is not personally liable for any part of the company's debt provided it is either a 'limited liability' or a 'public limited company'. Shares can be a comparatively risky form of investment.

Preference shares Carry a fixed dividend which is paid before dividends are paid to holders of ordinary shares. They have priority over ordinary shares if the company has gone into liquidation. They own part of the company but have no voting rights.

Price Earnings (P/E) Ratio Equal to the share price of a company divided by its EPS and providing a measure of how well the share price represents the ability of the company to generate earnings.

Prospectus Document which lists the financial and other details of an organisation which is seeking to issue new shares. An authorised prospectus is required under the Financial Services and Markets Act for any issue of transferable shares, or any issue of company shares, to more than 100 members of the public. An authorised prospectus is very expensive to prepare.



Public Limited Company (PLC) A well capitalised company that is certified to issue shares to the public.

Redeemable shares A time limited share that cannot be traded; the investor is repaid the nominal value of the shares on a specified date.

Rights Issue When a company raises capital from shareholders by issuing new shares to them pro-rata to their existing holdings. The new shares will be cheaper than the existing shares but they are under no obligation to participate. A rights issue can fail.

Scrip issue (Bonus issue) When free shares are issued to existing shareholders through a transfer within the company's reserves.

Securities Stocks, bonds and any investment with an element of ownership. Share premium. The difference between the nominal value of the company share e.g. 20p and the issue price e.g. 50p. The difference of 30p is in the accounts as the share premium account.

Share split When the nominal value of a share is split. As a result the number of shares is multiplied and the share price diluted in proportion. A company's share price will often rise on news of a planned share split or scrip issue. Investors prefer to have low-priced shares than high-priced ones. The reverse of a share split is a consolidation.

Sophisticated investor Someone who certified that they have bought shares recently or is otherwise a knowledgeable investor. Any company can offer shares to a sophisticated investor without an authorised prospectus.

Stock Any agreement that implies part-ownership of a business and gives the holder a claim on its assets. (But loan stock holders do not have any ownership rights or claim to assets other than the amount invested.)

Subordination If one creditor or investor agrees to receive repayment on dissolution only after another one has, they are said to be 'subordinate'.

User members In a Co-operative Society, the user members are the main stakeholders in and are entitled to join and vote on a one member, one vote basis. Non-users may have some voting rights, but users must have effective control: normally at least 75% of voting power. Dividends paid to user members should be no more than is necessary to attract and retain capital.

Venture Capital Tax Relief A tax relief for people investing in Venture Capital Trusts that themselves invest in businesses that would be eligible for Enterprise Investment Scheme.

Withdrawable shares Pay the investor the nominal value of the shares on request (subject to a period of notice) unless the governing body has suspended all withdrawals.

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