

## Chapter 7: Financing Community Interest Companies - Contents

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## 7.1. SHARE CAPITAL FINANCING

We thank Bates, Wells and Braithwaite for their kind permission to use their material. However, Bates, Wells and Braithwaite have not reviewed this guidance and are not responsible for its contents.

In Chapter 7 we have used as a source the publication: "Keeping it legal: legal forms for social enterprises; Bates, Wells and Braithwaite, SEL, 2003".

### 7.1.1. Financing: Companies limited by guarantee with no share capital

A community interest company limited by guarantee with no share capital (CLG) has no shareholders. The members give a guarantee to cover the company's liability, which is normally nominal and limited to, for example, £1. CLGs usually raise funds through grants or donations, rather than from shareholders.

### 7.1.2. Financing: Companies limited by shares

Details of the regulations and requirements concerning shares and share capital are available from Companies House.

### 7.1.3. Ordinary share capital

Each CIC that is a company limited by shares divides its share capital into units or shares of fixed amounts. This is known as the company's authorised share capital and each unit is formally known as an Ordinary share. Ordinary shares can have a nominal value of any amount (from 1p to £100 or higher); a nominal value of £1 is common, but this may, with notification to the Registrar of Companies be changed.

Ordinary shareholders usually carry the main financial risk if a limited company is unsuccessful because, if the company goes into liquidation, they are the last people to get their money back. Ordinary shareholders may be rewarded by dividends paid when distributable profits are available. CIC legislation restricts the payments a CIC can make out of profits (see the asset lock below).

CICs can issue shares 'partly-paid', but a community interest public limited company must have at least £50,000 of allotted share capital. Of this, 25% of the nominal value of each share and any premium must be paid up before it can get a trading certificate allowing it to commence business and borrow. Shareholders should be aware of the amount of their shareholding that is unpaid, as this represents a continuing liability, and may be asked for in the future.

#### **7.1.4. Preference shares**

The principal features of preference shares are that they pay a fixed dividend of, say, 5% each year, rather like an interest rate, however it is only paid if profits are available for distribution. They may accumulate to later years ('cumulative'), be repaid after a specified period ('redeemable') or convert from debt-style product (fixed interest payments) into Ordinary shares after a specified period or event ('convertible'). The details of these rights must be set out in the Articles of Association and should be clearly laid out and discussed with the Regulator to ensure conversion does not contravene the Asset Lock, and, in particular, the dividend cap.

Preference shares carry preferential rights over Ordinary shares in declaring profits, or on a winding up, but this reduced risk usually comes with less potential for reward.

#### **7.1.5. The asset lock**

The Asset Lock is the name given to the set of rules designed to ensure that CIC's assets are used for the benefit of the community: see Chapter 6. Legislation limits the maximum return investors can make on any investment in shares in a CIC to a level the Regulator considers to be reasonable.

The CIC Asset Lock does not apply to profits, or assets, distributed to specified asset-locked bodies or asset-locked bodies with the Regulator's consent (see below). An asset locked body is currently defined as a charity, another CIC, a permitted industrial and provident society, or an equivalent organisation set up outside the United Kingdom. A specified asset locked body is one that is specified in the Articles of Association as a possible recipient of the CICs assets.

To give meaningful reassurance to philanthropic investors in community interest companies (CICs), the cap has been set at a level, which precludes any private investors in the company from receiving 'windfall' profits. The cap on dividends to private investors (investors that are not specified asset-locked bodies or asset-locked bodies approved by the Regulator) means that CICs will generally attract equity financiers looking for modest rates of financial return, often over long periods, together with other social benefits. This may make CICs unattractive to some venture capitalists, with their expectations of high returns (for taking greater risks).

If a CIC wishes to pay dividends to private investors that are not asset-locked bodies it must adopt the provisions in Schedule 3 (rather than Schedule 2) of the Community Interest Company Regulations 2005 in its articles of association.

No dividend may be declared by a CIC (whether to an asset-locked body or otherwise) unless it has been approved by an ordinary or special resolution of the company's members – even if the CIC's articles provide otherwise.

Like any company, CICs can only pay dividends out of profits available for distribution under company law and the relevant accounting rules ("distributable profits"), and 3

commercial prudence may restrain them from paying out all the available profits in any given year.

If an asset-locked body holds shares, then there is no additional constraint on the payment of dividends, provided that:

- ❖ Either the Regulator has consented to the payment; or
- ❖ the asset-locked body concerned is named, as a possible recipient of the company's assets in its articles.

The dividend will be subject to the dividend cap if shares are:

- ❖ not held by an asset-locked body, or
- ❖ they are held by an asset-locked body not specified in the Articles, as a possible recipient of the CIC's assets, and the Regulator has not consented to the payment of the dividend.

The Cap has three elements:

1. The maximum dividend per share limits the amount of dividend that can be paid on any given share. Currently, the limit is 5% above the Bank of England base lending rate.
2. 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.
3. The ability to carry forward unused dividend capacity from year to year to a limited extent. Currently the limit is 5 years.

For further details on the payment of dividends, see Chapter 6.

#### **7.1.6. Distribution on winding-up**

Ownership of shares confers no right to participate in the assets of a CIC on winding up, beyond the return of the capital originally invested and any unpaid dividend.

#### **7.1.7. Regulation of share issues**

The raising of finance by means of shares issues is subject to a number of overlapping schemes of regulation and should never be undertaken without professional advice. The detail of the relevant legislation goes beyond the scope of this guidance. However, the following points should be noted.

As a matter of company law, a private limited company must not offer its shares to the public. The definition of what constitutes an "offer to the public" for these purposes is

a broad one, although offers made to existing members or employees of the company and their immediate families are not caught by the prohibition.

Under financial services law, invitations to invest, known as "financial promotions", are prohibited, unless they are issued, or approved, by someone authorised to give financial advice (usually an accountant), or unless a specific exemption from the prohibition applies. See the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 and the Financial Services Authority's guidance on the financial promotions regime at <http://fsahandbook.info/FSA/html/handbook/PERG/8>.

Furthermore, where transferable securities are to be offered to the public, the Financial Services and Markets Act 2000 generally requires that an "approved prospectus" must have been made available to the public. The term "transferable securities" covers a wide variety of share offerings by companies of any description, including CICs. Circumstances in which an approved prospectus is not required include:

- ❖ Where the total consideration of the offer is less than 2.5 million euros (or equivalent);
- ❖ Where the offer is only made to or directed at "qualified investors"; and
- ❖ Where the offer is made to or directed at fewer than 100 persons (other than qualified investors) per state in the European Economic Area.

Listed companies (PLCs listed on e.g. the London Stock Exchange) making public offers of shares are subject to additional regulatory requirements.

#### **7.1.8. Patient capital investment into the social enterprise sector**

The CIC has been created as a useful vehicle for social entrepreneurs, both those wishing to invest funds and others pursuing activities for the public or community benefit. The CIC is intended to be attractive to investors seeking community, social, or environmental, benefits alongside (sometimes sub-market) financial returns, accruing over long periods. They include individuals, retail and wholesale investors, charities, corporates and investment funds and public (regional, national and international) bodies.

Shares in social enterprises are not at present traded on a dedicated, formal stock market. This reduces investors' ability to sell their shares unless they are themselves aware of another person who wishes to invest in the shares. The two main sale routes are the 'matched bargain' facilities offered by specialist institutions (banks or stockbrokers match requests of those wishing to sell shares with those wishing to buy and social enterprises using profits (or funds raised through further share issues) to repurchase their own shares). It is expected that CIC investors would be able to trade

shares in successful CICs in the same way, and it is hoped that in time, a market for CIC shares will develop.

General information on Finance and Grants is available at [www.businesslink.gov.uk](http://www.businesslink.gov.uk). Further information and potential sources of patient capital include:

- [www.governmentfunding.org.uk](http://www.governmentfunding.org.uk)
- [www.access-funds.co.uk](http://www.access-funds.co.uk)
- [www.j4bgrants.co.uk](http://www.j4bgrants.co.uk)
- [www.grantsonline.org.uk](http://www.grantsonline.org.uk)
- [www.biglotteryfund.org.uk](http://www.biglotteryfund.org.uk)
- [www.bridgesventures.com](http://www.bridgesventures.com)
- [www.uksif.org](http://www.uksif.org)
- [www.esf.gov.uk](http://www.esf.gov.uk)
- [www.esmeefairbairn.org.uk](http://www.esmeefairbairn.org.uk)
- [www.unltd.org.uk](http://www.unltd.org.uk)
- [www.cafonline.org/venturesome](http://www.cafonline.org/venturesome)

## 7.2. LOAN CAPITAL AND DEBENTURES

Most enterprises have relationships with banks for the provision of loans. The transparent and well known company form that the CIC is based on is intended to allow financiers to make a better assessment of the risks involved than has sometimes been possible in the past as a result of lack of familiarity with social enterprise structures.

CICs will be able to borrow at normal commercial rates of interest, based on banks' assessment of risk and expected repayment term. Lenders typically take account of factors, such as:

- ❖ The general market conditions;
- ❖ The underlying business proposition and business plans;
- ❖ Current and past performance;
- ❖ Expected future performance;
- ❖ Company structure;
- ❖ Management competence;
- ❖ The company's existing levels of debt; and
- ❖ The extent to which the loan is secured against the company's assets, or payment of the loan is guaranteed by a third party.

This list is not exhaustive.

Many CICs, like other small businesses, are likely to need only simple funding services, such as an overdraft facility to smooth cashflow difficulties; or a mortgage, or loan, to finance an item of capital expenditure repayable, with interest (in a lump sum, or in instalments over the period of the loan).

However, subject to compliance with the principles of the asset lock, there is no reason why a CIC should not use any of the more complex forms of loan finance appropriate to its financial circumstances and business needs.

Interest rates on CIC borrowing must be at normal commercial rates. Unduly high debt repayments restricting the funds available to pursue the main activities of the CIC are outlawed by existing company law provisions on directors' duties and (in cases of outright fraud) by criminal proceedings, as for any other company.

The CIC regulator has powers to deal with clearly excessive debt repayments which, while not fraudulent, would amount to a breach of the statutory obligations on CICs to maintain the asset lock and pursue its public or community benefit purpose.

The term "debenture" is sometimes used in connection with borrowing by companies. A debenture can be any document which creates or acknowledges a debt, but it is most frequently used either in connection with lending against the security of the company's

assets (mortgage debentures) or to describe the issue of corporate bonds (where the company, instead of borrowing under contractual arrangements with financial institutions, sells bonds in exchange for cash to investors more generally: the investors then receive specified interest and capital repayments, and may in addition be able to make a profit by trading in the bonds themselves).

### **7.2.1. Lenders to the third sector**

The appropriate type and source of finance is always dependent on a company's circumstances – we recommend that professional advice be taken. The high street banks are the most significant overall providers of funding and financial services to small and medium-sized enterprises. Most have dedicated teams supporting social/community enterprises.

At the national level, there are some financial institutions that look particularly favourably on social enterprise: [www.charitybank.org](http://www.charitybank.org); [www.triodos.co.uk](http://www.triodos.co.uk); [www.icof.org.uk](http://www.icof.org.uk); [www.lif.org.uk](http://www.lif.org.uk); [www.primeinitiative.org.uk](http://www.primeinitiative.org.uk); [www.princes-trust.org.uk](http://www.princes-trust.org.uk); [www.street-uk.com](http://www.street-uk.com).

Government supported investment funds appropriate for some social enterprises include Adventure Capital Fund and Futurebuilders. The Small Firms Loan Guarantee scheme (<http://www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId=1074447105>) is a UK-wide, government-backed scheme to provide guarantees on loans to small firms with viable business proposals that are unable to obtain conventional finance because of a lack of security. Loans are provided by banks; the government guarantees 75 per cent of the loan.

Regional social enterprise support agencies can put you in touch with appropriate finance providers operating below the national level. See [www.socialenterprise.org.uk/regions.aspx](http://www.socialenterprise.org.uk/regions.aspx) for details.

Community Development Finance Institutions have been established expressly to support social enterprises, and operate in many different parts of the country, offering a variety of services, including loans. The government provides relief to tax-paying investors choosing to invest in CDFIs of 5% of their investment per annum, up to 25%. See [www.cdfa.org.uk](http://www.cdfa.org.uk) for details.

### 7.3. DEBT WITH EQUITY CHARACTERISTICS

Purchasing a company's shares ("equity investment") and lending money to it ("debt finance") are normally thought of as distinct forms of finance. In many cases, the equity investor takes a much greater risk than the lender of money. There is no certainty that a company will ever pay a dividend on its shares, or that it will be possible to sell a share for the same amount as the investor paid for it (or more). Unless the borrowing company gets into financial difficulties, it is likely that the lender of money to it can be more sure of receiving a return (in the form of interest and capital repayments) than many equity investors. On the other hand, if the company performs much better than expected, the lender does not normally have the equity investors' ability to make a return which is greater than that originally expected. The potential for both "upside" and "downside" with equity investment is therefore greater than it is with debt finance.

However, investors who wish to benefit from the greater relative security of returns provided by debt finance, but also to enjoy some of the potentially greater "upside" of equity investment may choose to lend to a company where the rate of interest payable on the loan is linked to some aspect of the financial performance of the company (as manifested in its profits, turnover, or an item on its balance sheet). If the company performs well, then the lender's rate of return is greater. Such arrangements are often referred to as "debt with equity characteristics", because of the performance-related element in them.

So as to ensure that performance-related lending is not used as a way of avoiding the asset lock, the legislation imposes a limit on the rates of interest, which can be charged in such arrangements. The current "interest cap" (which only applies to performance-related loans) is Bank of England Base Rate + 4 % (for further details, see Chapter 6).

#### 7.4. CHARGES ON ASSETS

CICs are governed by company law. Unless it is prevented from doing so by its constitution, a company can **mortgage** its assets to a lender in a wider and more flexible way than an unincorporated association, partnership or sole trader can. A mortgage by a company (usually called a charge) over land, vehicles and other property has to be registered at Companies House within 21 days of its creation.

Companies and CICs can give a 'floating charge' that applies to assets, which fluctuate e.g., stock or debtors. The floating charge hangs like a net above the assets charged. At the moment the charge is triggered or 'crystallises', the net drops and covers all the charged assets at that moment. The floating charge is only triggered when certain conditions set out in the terms of the charge, or loan facility under which the charge was given take effect.

Borrowing may entail providing debt **covenants** to lenders restricting the use of assets financed by the loan, dividend payments and further borrowing. Such covenants restrict the flexibility of the borrower and need careful consideration, particularly where community assets are at risk should loans not be repayable.

## **7.5. OTHER SOURCES OF FINANCE**

A trading enterprise's principal source of financing will usually be its **trading income**. In this way, users of goods and services provided by a CIC will be investing in the ongoing sustainability of the organisation. Cash reserves built up out of profits are available for the benefit of the community or reinvestment in the business.

### **7.5.1. Grants**

Grants may be available dependent on the expected activities and impact of a CIC's work. Grants are usually targeted at specific projects or for one off capital purchases. Some grant-makers may provide start-up or running costs, or give funds for investment in property and equipment, or for research and development or training.

Although grants have the clear advantage of being non-repayable, conditions attached to them designed to ensure that the money is used for the purposes intended may limit the capacity of an organisation to operate and expand or leverage in commercial finance (for example, some grant-making bodies will not lend to companies limited by shares which have the potential to pay dividends). The dependence on social impact, rather than ability to repay, the risk of donors changing priorities, their short-term nature and payment in arrears often result in grants inhibiting businesses from operating on an effective commercial basis.

### **7.5.2. Asset based lending**

Asset based lending is a flexible form of finance which allows businesses to secure funding against debtors (via invoice discounting or factoring), stock, plant and machinery and property. It can be particularly useful to fund seasonal stocking requirements, or to provide increased short-term leverage.

### **7.5.3. Employee share ownership schemes**

Employees may like to invest in shares to take ownership of a business. There are certain tax concessions to facilitate this, however, there is also a risk for employees: if they are asked to invest in their employer only to find that if the business becomes insolvent they have lost their savings as well as their job.

## **7.6. TAX, RATE RELIEF, GIFT AID & LOAN OR EQUITY FINANCE**

CICs will not receive tax breaks from the Inland Revenue by virtue of their legal status. The payment of corporation tax is the responsibility of individual companies, and appropriate professional advice should be sought when considering what your business's tax liabilities are, and how it might be structured in a more tax-efficient way.

However, as with any company deductions for tax can often be made against capital expenses and against some of the costs of running a business, such as training.

### **7.6.1. VAT**

There is no general exemption from VAT for social enterprises that undertake trading activities. VAT is a tax on turnover ('taxable supplies' over £67,000 in 2008/9), and is based on the nature of the good or service supplied. Enterprises operating without a profit motive are still liable to pay VAT, however, those engaged in provision of education, health or welfare may find exemptions. Further detail can be found on the HM Revenue and Customs [website](#).

### **7.6.2. Discretionary rate relief**

In some circumstances local government may provide discretionary rate relief to social enterprises.

### **7.6.3. Gift aid**

A CIC cannot apply to Inland Revenue for Gift Aid status.

### **7.6.4. Donations to charities**

If a CIC donates surpluses to a charity it will be able to deduct the amount of any such donations as a "charge" when working out its profits for corporation tax purposes. This may be of particular interest to those CICs setting up as the "trading arm" of a charity. See the HMRC pamphlet entitled "[Giving to charity by business](#)" & "[How businesses can get tax relief](#)".

### **7.6.5. Loan or equity finance**

In terms of the cost of raising finance, loan finance will sometimes be more tax efficient for a company than equity investment. This may influence the debt and equity levels a CIC chooses.