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March 2021

Reality Check: As the Chancellor Turns off the Taps, There are Uncertain Times Ahead

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To what extent will the scale of the support provided by the Government and new legislation enacted in 2020 impact businesses as they seek to bounce back from the pandemic?

During the global COVID-19 pandemic, UK Government support has been crucial, even for some of the largest businesses in the UK that had been trading well until the pandemic hit.

The overall quantum of support is unprecedented, with the total cost of COVID-related business, employment and other support measures expected to surpass £300bn.

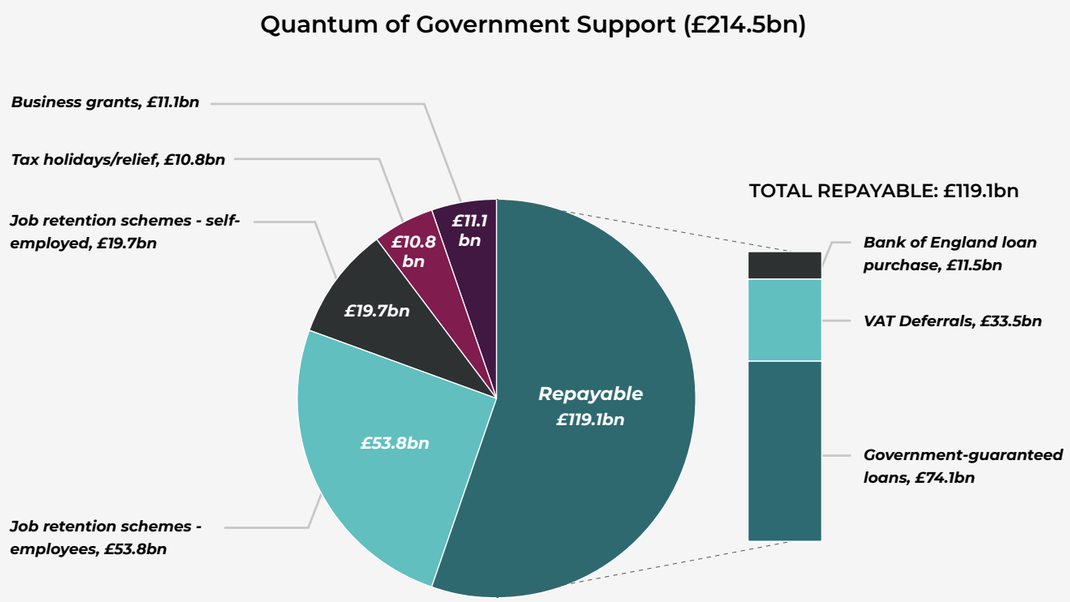
Of this total, £85.6bn remains outstanding in the form of Government-guaranteed loans and a further £33.5bn of VAT was deferred in Q2 2020. The question remains as to how and to what extent businesses will be able to meet the associated repayment requirements.

To further complicate matters, UK Parliament enacted two pieces of legislation that significantly change the landscape for businesses facing financial difficulties:

- The 2020 Finance Act, effective 1 December 2020, that re-introduced Crown preference - elevating the seniority of debts owed to HMRC above floating charge holders; and
- The 2020 Corporate Insolvency and Governance Act (CIGA), effective 26 June 2020

There is no doubt that without the scale of the support provided to UK businesses to date, the number of failures would have been catastrophic for the economy. Yet at the same time, the commercial reality of the repayable measures and the new legislation are not fully understood.

This article explores the likely implications and potential uncertainties arising from these events for businesses, with specific focus on audit sign-off, lender and Government behaviour and directors' duties.



Note: the graph above is an illustration of the total quantum: it encompasses data as available, and does not include elements that are not quantifiable (such as partly reduced VAT rates, and the "Eat Out to Help Out" scheme)

Sources:
https://www.gov.uk/government/collections/hm-treasury-coronavirus-covid-19-business-loan-scheme-statistics
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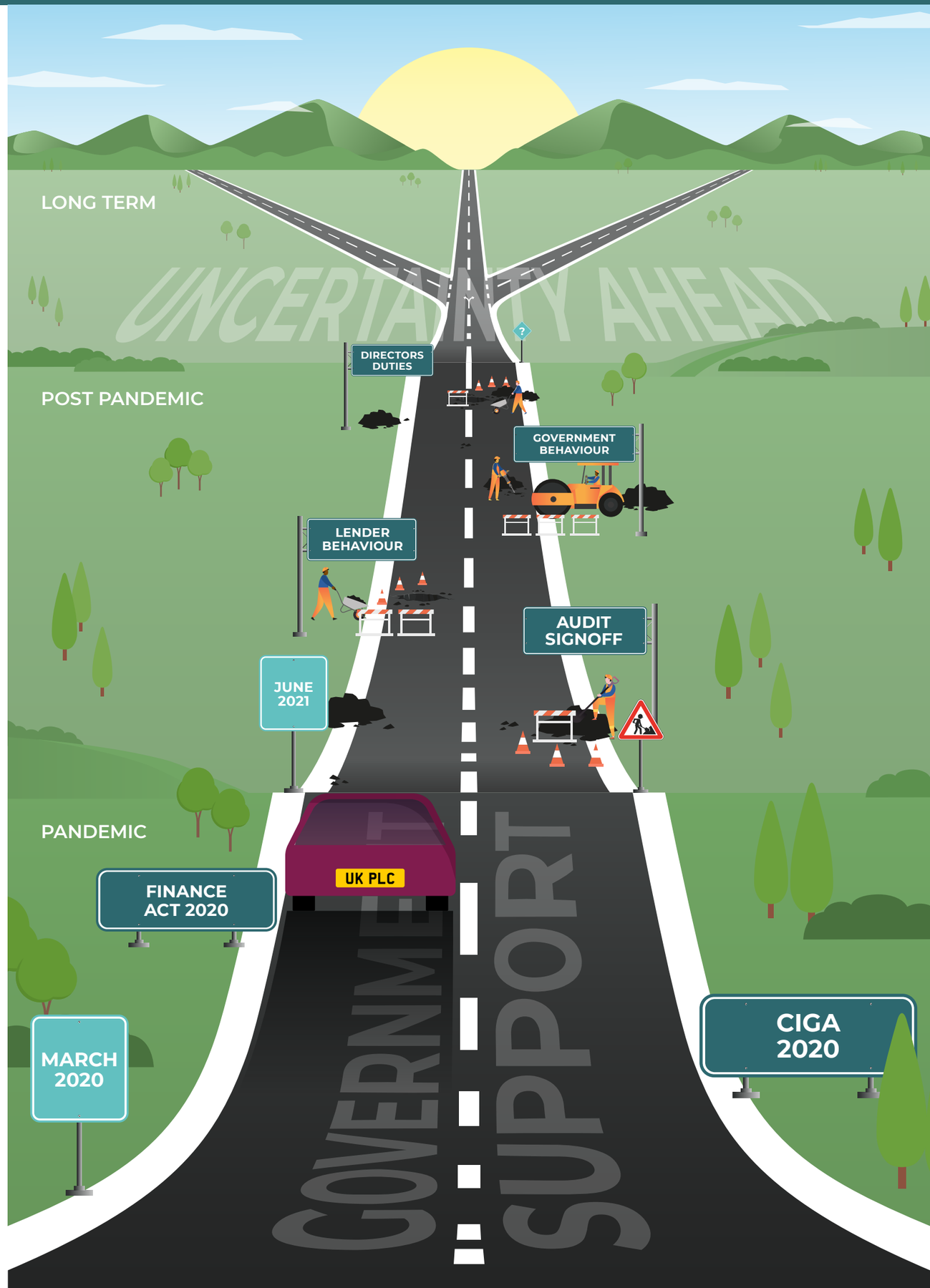


Government Support: Guaranteed Loans and VAT Deferrals

The Spring Budget confirmed timing for businesses to start repaying some of the support provided to them, but just how much is owing to the Government and HMRC?

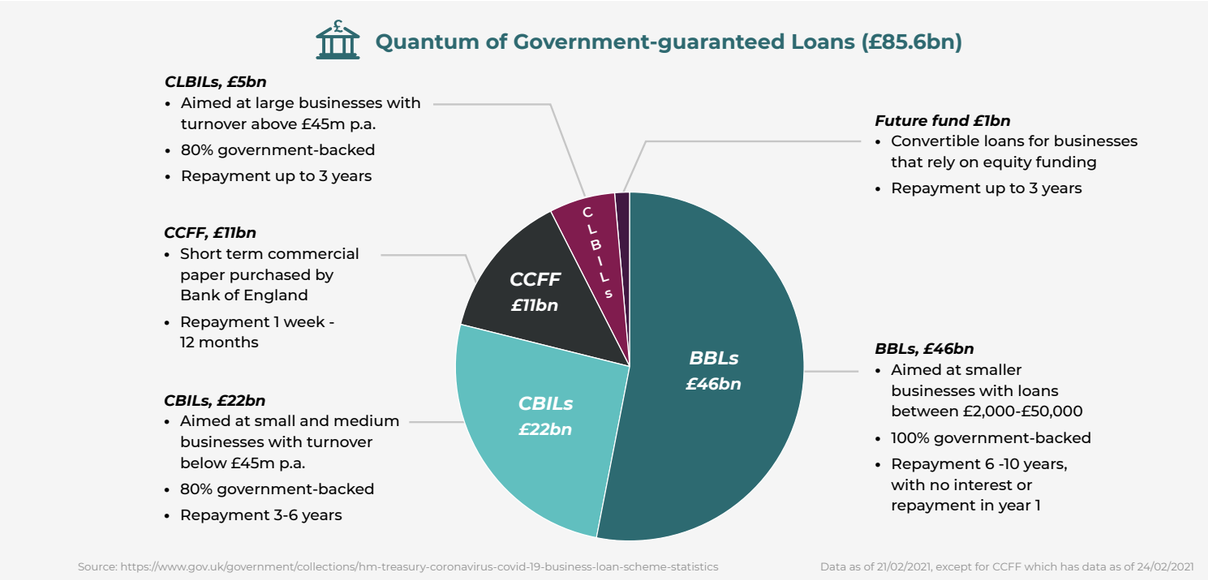
Government-guaranteed loans:

In 2020, the average monthly net new funding raised from banks and capital markets by UK businesses was £4.9bn. To provide context, between 2011 and 2019 the equivalent monthly figure was £1.4bn. To deal with the potential liquidity impact of the pandemic, businesses borrowed an extra £3.5bn (250% more) per month.

Much of the new lending which resulted in this net increase came from the five different Government schemes shown in the chart below.

On 3 March 2021, as part of the Chancellor's Spring Budget, it was announced that the Government would introduce a further guaranteed loan scheme, to replace the current schemes that expire on 31 March 2021.

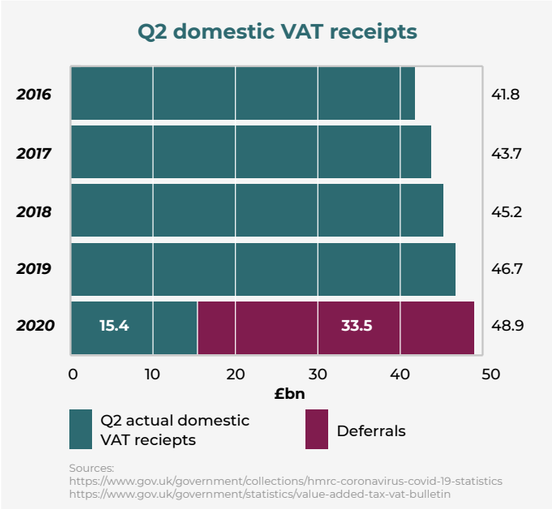
The "Recovery Loan Scheme" (RLS) ensures businesses of any size can continue to access term loans, overdrafts, invoice and asset financing up to £10 million per business, with 80% backed by a Government guarantee. RLS will expire on 31 December 2021.



VAT Q2 2020 Deferral

The total amount of VAT deferred in Q2 2020 was £33.5bn (representing c17% of total VAT receipts in 2019) and was initially due for repayment by March 2021. On 24 September 2020, with the continuing restrictions, the Government announced that the rules around repayment would be relaxed, allowing businesses to repay in 11 monthly instalments by March 2022 commencing April 2021. The scheme was formally launched in February 2021 and companies must opt into this scheme by 21 June 2021.

The graph to the right shows HMRC domestic VAT receipts as compared to other periods, giving some context to the amount that was deferred.



New Legislation: Finance Act 2020

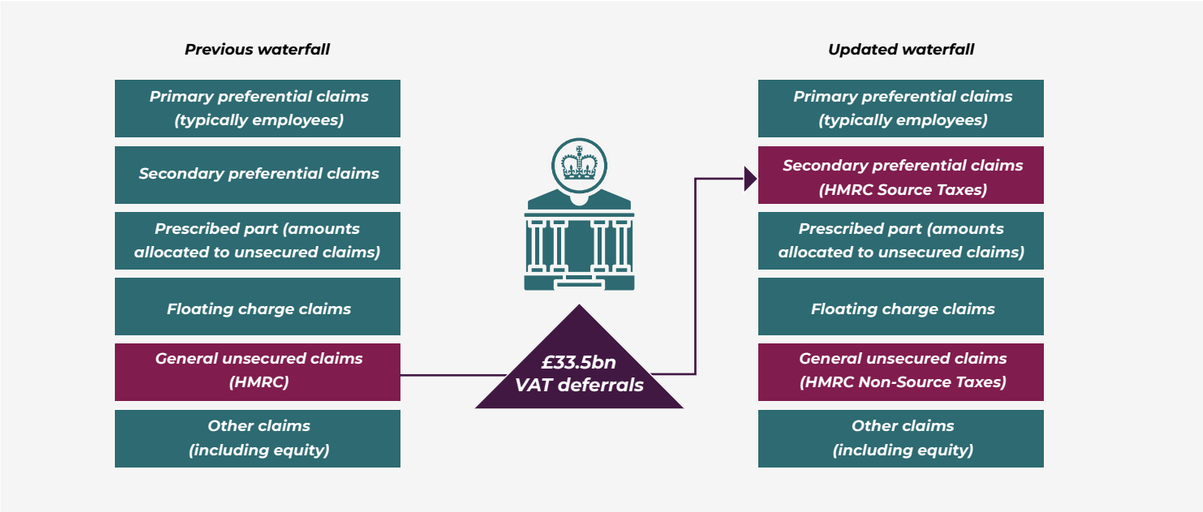
The reintroduction of Crown preference proves there is no such thing as a free lunch. What does this mean for businesses and their lenders?

The reintroduction of Crown preference was included in the delayed 2020 Finance Act notwithstanding the unfolding global pandemic. This involved:

- The promotion of "Source Taxes" (i.e. taxes deducted at source by companies including VAT, PAYE, income tax and NICs) within the insolvency waterfall, now ranking them above floating charge holders; and
- No cap (in quantum, or in age) on the Source Taxes that can be collected as preferential debts.

Material amounts of Source Taxes deferred as part of Government support packages now have priority over any existing floating charge holders in the event of insolvency.

This creates further complexity for both directors and lenders in future restructurings or requests for provision of additional liquidity.



Other features of the Act worth noting:

- The increase of the prescribed part (i.e. amounts ring-fenced for general unsecured claims) from £600,000 to £800,000, further eroding value for floating charge holders.
- In certain circumstances, HMRC, in a bid to tackle "Phoenixing" of companies, will have the power to make individuals connected with the company (including directors) jointly and severally liable for tax debts.

New Legislation: CIGA 2020

Two elements of new Corporate Insolvency and Governance Act (CIGA) 2020 appear to change the landscape for businesses, their directors and other stakeholders. What impact do they have in practice?

- **The introduction of a cross-class cram down mechanism:** A restructuring outcome can be enforced on a single class of creditors who may disagree with the restructuring solutions proposed by other creditors.
    - This could mean that floating charge lenders may face even greater losses should they be "crammed down" in the event of a restructuring; and
    - Significant losses could also be forced onto the Government backed loan creditor class, further risking the Government's capital.
- **The revisiting of the concept of "Wrongful Trading" for directors:** For the duration of the pandemic, CIGA reduced the risk of wrongful trading, whereby directors can be ordered to contribute to the company's assets should creditors' positions worsen after they should have known an administration or liquidation could not be avoided.
    - This measure was initially for the three-month period beginning 1 March 2020 but has since been extended to cover the period until 30 April 2021.

Repayment Profile

Businesses will soon be required to start repaying Government support packages. With so much uncertainty for businesses around the bounce back in operational cash flows, what impact will this have?

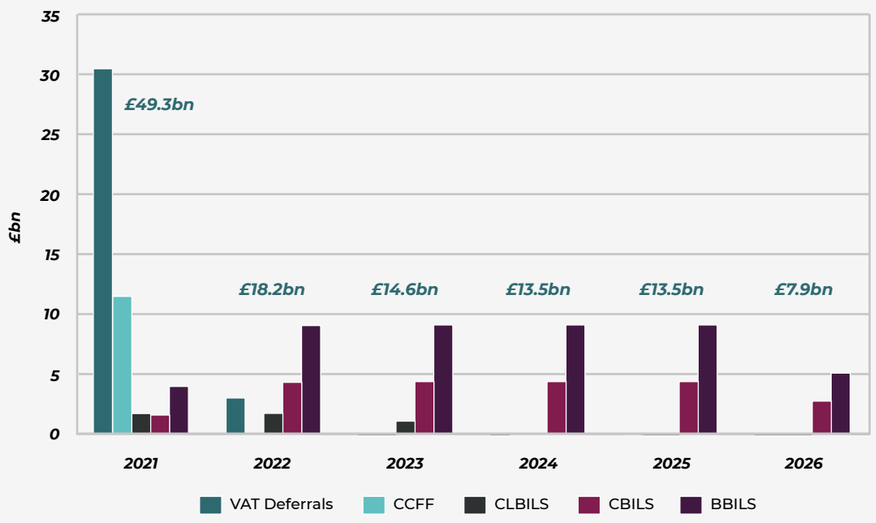
Whilst Government schemes have alleviated liquidity challenges in the short-term, the medium-term impact on companies' solvency is uncertain. For many businesses, operational cash flows will take months, or even years, to recover with uncertainty around what the 'new normal' will look like going forward.

In the absence of sufficient collateral, it is unlikely that commercial lenders will be prepared to advance additional funding to facilitate repayment of VAT (or other deferred taxes) to HMRC.

This is a catch-22 for businesses as, until HMRC debts are repaid, lenders may be unwilling to provide additional facilities to businesses to aid liquidity (or repay other forms of Government support), unless such lending can be secured against fixed charge assets.

Estimating the repayment profiles for Government-guaranteed loans is not straightforward. Terms of financing are agreed directly between the lender and the company, so data is not readily available. The chart below illustrates a high-level estimation of the repayment profile facing businesses over the coming years.

Estimated Repayment Profile



Key assumptions: Repayment profiles are calculated based on maximum duration allowed in each scheme and payment in equal instalments. No interest is assumed as rates differ substantially between providers.

Sources:
https://www.gov.uk/government/collections/hm-treasury-coronavirus-covid-19-business-loan-scheme-statistics
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Businesses will eventually be forced to repay the loans in the short to medium-term and depending on the time taken for businesses' operations to fully recover, this may mean seeking funding from either capital or credit markets, which may be difficult if any material amounts remain outstanding to HMRC.

Implications of Government Support and New Legislation

	Likely implications	Uncertainty ahead

Audit sign-off	• FRC: "We expect, given the current uncertainty and volatility, that more companies and auditors may need to consider reporting on material uncertainties"
	• More material uncertainties around the going concern assessment and perhaps more qualified audit opinions
	• A larger focus by auditors on business plans and financial models as part of audit procedures around going concern
	• ·Requirement for management to work more closely with financial and other stakeholders to satisfy themselves (and give auditors the maximum possible comfort) on going concern
		• Whether companies will face the same consequences of a qualified opinion or material uncertainty as previously e.g.:
		  • Difficulty in obtaining new financing;
		  • Triggering of an event of default in existing financing; or
		  • Other operational complications such as credit insurers increasing their premiums or withdrawing coverage

Lender behaviour	• Less willingness to advance new loans or roll over existing debt • More restrictive lending criteria • Higher interest rates/lender fees • More extensive due diligence on a borrower's historical tax affairs • Tighter covenant packages generally and specifically around payments and exposures to HMRC • Lenders seeking more fixed rather than floating charge financing • Lenders requiring shareholders to inject further capital to compensate lenders for their lower position within the waterfall	• Appetite for enforcing all potential avenues of recovery of Government COVID loans, rather than seeking the Government guarantee as soon as possible • This may, in turn, lead to more restructuring scenarios in which the Government is a key stakeholder
Government and HMRC behaviour	• More prominent role in restructuring situations due to Crown preference and defaults of Government guaranteed loans	• The extent to which HMRC will enforce insolvencies to recover taxes, rather than voting in favour of other commonly used restructuring processes, such as Company Voluntary Arrangements (CVAs) • Alternatively, the extent to which HMRC will work with management teams to seek restructuring solutions so that creditors as a whole are not prejudiced • How the Government will deal with guaranteed COVID-19 loans that default
Directors' duties	• The re-application of the "Wrongful Trading" assessment to pre-pandemic levels • Higher risk of being personally liable in certain circumstances for company tax debts • Increasing premiums for Directors and Officers (D&O) insurance	• Auditor / lender / Government behaviour arising from the pandemic • The extent to which D&O insurance costs may rise to become unaffordable and Boards seek alternative protection

Faced with all of these uncertainties, now more than ever stakeholder management, clear communication and production of robust cashflow forecasts and business plans are essential for businesses. Directors should also ensure their company receives robust legal, tax and financial advice to mitigate directors' risk

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