

Essential, Authoritative Analysis and Opinion for Board Directors, Senior Executives, Investment Professionals and Advisers

# All change EU Company Law Action Plan Pension Provision

"Today's measures provide a sound platform for auditors, companies and investors alike to work together to strengthen financial reporting and corporate responsibility in the UK."

*Neil Lerner, Global Head of Regulatory Issues at KPMG*

"The priorities we now set in the Action Plan must be conducive to entrepreneurship and making the most of the potential of the international dimension."

*EU Commissioner Charles McCreevy*

"Many employers are now throwing up their hands and saying that pension planning for executives is too hard."

*Paul Jayson, Head of Actuarial Consulting & Benefits at Higham Group*

EDITORIAL	2	<b>Good investor, bad investor</b>
NEWS	3	<b>All change</b> Sweeping changes designed to simplify and improve company law have been unveiled in the Company Law Reform Bill
INTERNATIONAL	4	<b>The future of the EU Company Law Action Plan</b> At a recent conference in London, EU Commissioner McCreevy set out the agenda for future reforms
	5	<b>German governance and hedge funds</b> <b>Jella Benner-Heinacher</b> looks at the lessons which can be learned from the recent problems at Deutsche Börse
GLOBAL NEWS	6	<b>New academy launched for directors</b> <b>Innovative claw back provisions</b> <b>The FD's view</b> <b>International Audit Regulators' Roundtable</b>
FEATURES	8	<b>Tales of pride and prejudice</b> <b>Tracy Long</b> summarises changing attitudes to UK board evaluation during 2005
	10	<b>Pension provision</b> Executive pensions provision is complex and coming under increased scrutiny. <b>Paul Jayson</b> sets out the basic considerations

**Governance Publishing and Information Services Ltd**

Watchfield House, Watchfield, Highbridge,  
Somerset TA9 4RD, UK  
Tel: +44 (0) 1278 793300  
Fax: +44 (0) 1278 783750  
Email: [info@governance.co.uk](mailto:info@governance.co.uk)  
[www.governance.co.uk](http://www.governance.co.uk)



**EXECUTIVE EDITOR**

**Michelle Edkins**

Email:  
[medkins@governance.co.uk](mailto:medkins@governance.co.uk)

**PUBLISHER**

**Lesley Stephenson**

Tel: +44 (0) 1278 793300  
Fax: +44 (0) 1278 783750  
Email:  
[lstephenson@governance.co.uk](mailto:lstephenson@governance.co.uk)

**CONSULTING EDITOR**

**Kit Bingham**

Email:  
[kbingham@governance.co.uk](mailto:kbingham@governance.co.uk)

**AUSTRALIA, PACIFIC AND  
FAR EAST CONTRIBUTING  
EDITOR**

**Dr Geof Stapledon**

CEO  
Proxy Australia  
Level 5  
115 Elizabeth Street  
Melbourne, Vic 3000  
Australia  
Tel: +61 3 9642 2062  
Fax: +61 3 9642 2092  
Mob: 0414 643 215  
Email:  
[g.stapledon@proxyaustralia.com](mailto:g.stapledon@proxyaustralia.com)  
[www.proxyaustralia.com](http://www.proxyaustralia.com)

**EDITORIAL ADVISORY  
BOARD**

**Philip Armstrong**

Head, Global Corporate  
Governance Forum,  
Washington, US

**André Baladi**

Principal, André Baladi &  
Associates  
Co-Founder and former  
Co-Chairman of the Board of  
Governors, International  
Corporate Governance  
Network (ICGN)

**Stephen Davis**

President, Davis Global  
Advisors, Inc.

**Pierre-Henri Leroy**

Managing Director, ProxInvest.  
Co-Founder and former Board  
Governor of the ICGN

**Colin Melvin**

Corporate Governance Director,  
Hermes Investment  
Management

**Nell Minow**

Editor, The Corporate Library

**Robert A G Monks**

Principal, Lens LLP

**Dr Florian Schilling**

Managing Partner, International  
Board of Practice of Heidrick &  
Struggles, Frankfurt

**Dr Geof Stapledon**

CEO, Proxy Australia  
Professor, University of  
Melbourne

Michelle Edkins writes in a personal capacity. She is also a partner of Governance for Owners.

**Printed by**

JIMAS Offset Print, Unit 8,  
Morlands Industrial Estate,  
Burnham on Sea, Highbridge,  
Somerset, TA9 3ET

**Design by**

Tattersall Hammarling & Silk

**ISSN: 1358-5142**

© Governance Publishing 2005. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without written permission of the copyright holder.

# EDITORIAL

## Good investor, bad investor

Is there such a thing as a 'bad' shareholder? Hedge funds tend to be so branded because of their perceived lack of commitment to the companies in which they invest. Yet there is begrudging acknowledgement from directors and management of public companies that often the hedge fund investor in a company has done deeper and better research in advance of investing and, once invested, takes a greater interest in its affairs than the 'mainstream' investors. Perhaps what is controversial is that an increasing number of hedge fund investors are tending to use their in-depth knowledge to influence what the company does.

Hedge funds taking on a shareholder activism mantle create new pressures on companies. Directors are faced with informed but generally short-term investors who seek change that may, or may not, contribute to the creation of long-term shareholder value. The silence of the assumed long-term, mainstream investors who have chosen not to exert 'informed influence' leaves directors having to balance their interests with those of the hedge funds.

The problem with having a short-term agenda is that the hedge fund investor is

driven to seek change that will have an impact sooner rather than later. Directors for their part are driven to form and implement strategy in an ad hoc, even knee-jerk, manner that potentially threatens a company's stability and sustainability. Often the need for a short-term fix results in cosmetic change that does more harm than good over the longer term. Often it also means that campaigns for change are undertaken in the public arena which seldom reflects well on either party.

The rise of the activist hedge fund should act as a spur to mainstream investors to take up their ownership responsibilities. It is difficult to argue that some shareholders are good and others bad. After all, hedge funds are filling a gap in the market and many are creating value for their clients. And the gap was created by mainstream investors sitting idly by watching a company's performance decline and hoping that someone else will address its problems for them. What we need, is more mainstream long-term investors prepared to actively engage with companies to balance out the voice of the hedge fund investors and support boards in setting a long-term agenda.

## All change

Sweeping changes designed to simplify and improve company law have been unveiled in the Company Law Reform Bill.

Small companies have been particularly singled out for attention. Most of UK company law is aimed at larger organisations and this Bill does at least seek to lighten the regulatory burden on smaller companies, recognising that what is appropriate for larger corporations is excessive and too onerous for smaller companies. The provisions of the Bill relevant to smaller enterprises are:

- restructuring those parts of company law most relevant to small businesses making it easier for them to understand what they need to do;
- simpler rules for forming a company;
- abolition of the need for a company secretary;
- making AGM opt in rather than opt out; and
- new model articles.

The range of measures, affecting all businesses include:

- greater clarity on directors' duties, including making clear that they have to act in the interests of shareholders, but need to pay regard to the longer

term, the interests of employees, suppliers, consumers and the environment;

- greater use of e-communications and removing the need for hard copy share certificates; and
- an option for all directors to file a service address on the public record rather than a private address.

Shareholder engagement will be promoted through enhancing the powers of proxies and making it easier for indirect investors to be informed and to exercise governance rights in the company.

The Bill also includes proposals to introduce auditor liability and boost audit quality including:

- allowing shareholders to agree to limit the auditors' liability to the company, so the financial liability of the auditor relates to the auditors' responsibility for the loss;
- greater rights for shareholders to question auditors and named partners for audit reports; and
- audit reports to give the name of the individual lead auditor, as well as the audit firm (although provision is made for confidentiality in exceptional cases).


A new offence will be introduced for recklessly or knowingly including misleading, false or deceptive matters in an audit report. The Chief Executive of the Institute of Chartered Accountants in England and Wales (ICAEW), Eric Anstee, expressed the ICAEW's concerns over this provision, saying that, "whilst supporting the concept of a criminal penalty for auditors dishonestly issuing a false audit report, the use of the word 'recklessly' in the Bill will be seen to indicate that honest mistakes might result in criminal prosecution. The meaning of 'recklessly' in an audit context is unclear and there is no relevant case law to fall back on. Whilst we have been assured that the test for recklessness will be very high and that behaviour resulting from honest errors should not result in prosecution, we would welcome a statement from ministers clarifying the intent behind this in an audit context to reduce the likelihood of unintended consequences."

The Bill is used to implement the EU Takeover Directive, placing the work of the Takeover Panel on a statutory footing. It will implement the company law aspects of the European Transparency Directive (relating to disclosure of shareholdings), where the Bill would make the Financial Services Authority (FSA) the competent authority for the

rules which will be broadly similar to the current rules under Part VI of the 1985 Act. It also implements aspects of the EU Audit Directive.

A power is provided to require institutional investors to disclose how they have used their votes. This has not met with unanimous approval. Peter Montagnon, ABI Director of Investment Affairs, points out that there would be large compliance costs. "These are not justified when more and more institutions, led by insurance companies, are disclosing voluntarily" he said. The Bill also paves the way for the Financial Reporting Council to undertake regulation of the actuarial profession, following the Penrose Report into Equitable Life.

Commenting on the Bill, Neil Lerner, Global Head of Regulatory Issues at KPMG, said: "Today's measures provide a sound platform for auditors, companies and investors alike to work together to strengthen financial reporting and corporate responsibility in the UK."

*The Bill can be accessed through the UK Parliament website at [www.parliament.uk](http://www.parliament.uk) and a useful guidance note to the key provisions is available on the DTI website at [www.dti.gov.uk/cld/guidance/key.doc](http://www.dti.gov.uk/cld/guidance/key.doc)* 

# INTERNATIONAL

## The future of the EU Company Law Action Plan

On 14 November almost 400 delegates assembled in London for the European Corporate Governance conference hosted by the DTI in association with Hermes. The programme looked at the issue of governance from both an investor and a corporate perspective and there was also representation from the employees through Reiner Hoffman, Deputy General Secretary, ETUC.

The highlight of the day was the keynote speech from Commissioner McCreevy. As he pointed out, we are approaching the end of the first phase of the Company Law Action Plan and now is the time to start thinking about what should be done in the second phase. A wide-ranging public consultation will be launched over the next few weeks and Commissioner McCreevy set the scene for the issues that the EU thinks need to be considered.

Restoring investor confidence is no longer the main driver. "The impetus for what we do next at EU level must now be the tandem of: (1) improving the competitiveness of EU companies- the so-called Lisbon agenda; and (2) the EU's push towards better regulation," he said.

Despite having an Internal Market of over 450 million, it is difficult for companies to exploit this. According to the World Bank, only two Member States figure in the world's top ten countries and 11 in the top 30. "This simply is not good enough: it is not going to get the EU as whole to the top of the league. Much of what needs to be done lies in the hands of the EU Member States. But the EU must not shoot companies and Member States in the foot as they try to get out of the starting block.

If we have a competitive internal market, our firms will have better chances of competing successfully abroad. Globalisation might then be perceived not as a threat but as an opportunity. The priorities we now set in the Action Plan must be conducive to entrepreneurship and making the most of the potential of the international dimension."

Commissioner McCreevy set out four key themes for the future of the Action Plan:

1. Consultation with stakeholders (as mentioned above).
2. Only legislating at EU level where that is the

best level at which to act and where legislation is the only answer. He stressed the need to opt for instruments that put the least burden on companies and leave them as much flexibility as possible. Therefore, recommendation will always be preferred to a directive where a recommendation is suited to achieve the aim pursued, for example is a directive really needed on disclosure for institutional investors or is the market already moving in the right direction?

3. A comprehensive impact assessment for any new piece of legislation to be submitted to the Commission.
4. A three-year rolling programme of measures adopted recently by the Commission to simplify existing EU law, including the Company Law Directives.

He couldn't leave the podium without mentioning the issue of one share one vote. A recent interview he gave to the *Financial Times* where he said: "It is my goal to get the one-

share, one-vote principle accepted across the 25 Member States," led to much press coverage and debate on the issue. Commissioner McCreevy reiterated his views. "For me, the shareholder is king or queen: this goes back to what I said at the beginning about transparency and shareholder empowerment. If these principles are followed, I am convinced it will lead to companies which are better run. Pricing of shares on exchanges confirms that this is what the market tends to think. But I am not naive. I have heard about the fierce debates at the time the Takeover Bids Directive was negotiated and I have met the people who bear the scars. I believe, nonetheless, that this should not prevent us from looking into the merits of this principle. We are in the process of commissioning an outside study and our experts in the European Corporate Governance Forum are already looking into this issue."

Closing his remarks he asked the audience to keep in mind the overarching guiding principle, which is that European companies need and deserve a modern and flexible company law framework.

# INTERNATIONAL

## German governance and hedge funds

**Jella Benner-Heinacher**  
*looks at the lessons which can be learned from the recent problems at Deutsche Börse.*

It all started with the end of the so-called Deutschland AG.

Fifteen years ago the major German stock corporations were held by a majority of either large German banks or insurance companies. This system of cross shareholdings and cross directorships worked well and was the heart of the Deutschland AG. But times have changed since then. More and more international investors got interested in the German capital market, so the rules started changing and became more international.

Now Germany has its own Corporate Governance Code, developed by a Commission under the lead of Dr Gerhard Cromme, the 'Cromme-Code', and beyond this, a selection of new laws have been introduced to make Germany an attractive capital market for international investors.

Nowadays, the DAX 30 companies have only a few large shareholders, the German banks and insurance companies divested themselves of

their shareholdings and international investors took their place.

Unfortunately, this development is not all positive. Since the 1990s the DAX 30 companies have experienced a heavy decrease in their voting turnouts from 60 per cent down to 45 per cent in 2005. These low turnouts can mean that at the Annual General Meeting, resolutions can be swung by the minority shareholders actually forming the majority. It could be argued that all institutional investors, whether German nationals or international investors, are probably reluctant in exercising their voting rights, but under German law, German mutual funds such as DSW and Union

In the past four years the volume of the hedge fund portfolio increased from four hundred billions to one trillion US Dollars.

Investment have to vote their German shares. Unfortunately, the same is not true for the foreign investors such as the mutual, pension or even hedge funds. So, what needs to be done?

### **Better solutions to facilitate cross-border voting**

Even the EU Commission has recognised that things have to change in order to make cross-border voting easier. The Commission launched a consultation on 'Shareholder Rights' last year focusing on important issues such as cross-border voting, stock lending and corporate governance.

Germany is already taking the lead in this. It has just introduced by law ('UMAG') a record date of 21 days before the General Meeting to enable all shareholders, particularly foreign shareholders, the time to vote all of their German shares.

### **Introduction of a voting bonus for Germany**

DSW and other important players in the German capital market very much favor the introduction of a voting bonus, i.e. a premium paid by the company to those shareholders who voted their shares at the General Meeting.

DAX 30 companies with a high percentage of free float and therefore no major shareholder have already shown great interest in this proposal. The German Ministry of

Justice is already working on concrete plans to change the German law to enable the companies to introduce such a premium by altering their by-laws with the approval of the shareholders.

### **Are special rules needed for hedge funds?**

As the case of Deutsche Börse has shown, hedge funds do play an increasingly important role as active shareholders. But can we really draw the line between 'bad' and 'good' shareholders? No, we cannot.

In the past four years the volume of the hedge fund portfolio increased from four hundred billions to one trillion US Dollars. In the view of DSW hedge funds are shareholders just like any others. It should also be remembered that hedge funds can be important players in a well functioning and efficient capital market. And the rule of the equal treatment of all shareholders should not exclude hedge funds.

On the other hand the other investors, especially small shareholders should have the opportunity to decide on their own whether they want to stay in their company after the entry or the exit of large investors such as hedge funds.

# GLOBAL NEWS

## German governance and hedge funds continued

Obviously, these large investors cannot be forced to disclose their objectives and their investment strategy. Nevertheless, there is a strong need for the disclosure of more information. Corporate governance is not only applicable for companies, but should also include their shareholders.


This could mean:

- a lowering of the thresholds for disclosing shareholdings in Germany in order to inform the market much earlier of the entry/exit of new investors, e.g. investors who exceed three per cent of the shares have to inform the company and the German SEC (the threshold is currently five per cent);
- the introduction of new thresholds between the now existing five per cent, 10 per cent and 25 per cent thresholds in order to increase the transparency of the market altogether, for example introducing new thresholds at seven per cent and 15 per cent;
- in addition to these steps, we should think about new thresholds for takeover offers. Why should Germany stick to 30 per cent of the voting rights as the threshold for takeover offers, if the voting turnout of the largest German companies is 45 per cent on average and would enable a shareholder to control the company by holding only 23 per cent of all shares? Why shouldn't we introduce a new threshold at 25 per cent?

What is the final conclusion we can draw from looking at what happened at Deutsche Börse and some of its shareholders?

Good corporate governance includes a fair and equal treatment of all investors, whether small or large, good or evil. This is one of the most important skills of management nowadays, at least in quoted companies, and it also includes a clear and easily understood communication of the company's strategy to all shareholders.

*Jella Benner-Heinacher is Managing Director of DSW, Hamborner Str. 53, 40472 Düsseldorf*

Tel: +49-211-669722  
Fax: +49-211-669790;  
[www.dsw-info.de](http://www.dsw-info.de) 

## New academy launched for directors

Accountancy firm Deloitte has launched a new academy, based at dedicated premises within their London headquarters in Stonecutter Court, which will offer a programme of technical training, support and guidance on management and governance issues to directors of publicly-listed companies. A full programme of events will start in January 2006, with e-learning courses also available for remote training.

Martin Eadon, Deloitte's Chief Operating Officer, said the academy was not a money-making venture, but a way to help directors keep up with an ever growing body of complex legislation.

"Business leaders are faced with an unprecedented volume of change," he said. "These changes are not going to go away so directors are going to have to deal with them and at the same time remain competitive."

[www.deloitteacademy.co.uk](http://www.deloitteacademy.co.uk) 

## Innovative claw back provisions

London-based F&C Asset Management has hired a law firm to draft a universal employment contract that would enable companies to 'claw back' salary and bonus payments after executives leave troubled companies. According to Karina Litvack, Head of Governance and Socially Responsible Investment at F&C, "We have hired employment lawyers to come up with model language for contracts. We are hopeful this will be emulated by others in the industry." F&C has sent its draft contract to the Association of British Insurers, which is working to revise its remuneration policies. The proposal includes a clause that company payments can be recouped from executives when paid in error when remuneration committees did not know the full facts about a company's finances at the time they were awarded. Ms Litvack said the claw back should be immediate if financial statements have to be restated after an executive's departure or if there were later findings of fraud. F&C also hopes to come up with wording that will enable cash to be clawed back from executives judged either incompetent or negligent.

[www.fandc.com](http://www.fandc.com) 

# GLOBAL NEWS

## The FD's view

The quoted sector has become a dramatically less attractive place to work compared to private opportunities, according to Europe's finance directors. Feeling the pressure from regulatory intervention, investor scrutiny and hedge fund activism, half of European CFOs said that the public markets have become a less attractive place to be employed in the past two years, according to a recent poll. UK finance directors agreed with this view by a ratio of two to one.

These concerns emerged in the European CFO poll, conducted by Richard Davies Investor Relations on behalf of Financial News and SG CIB, the corporate and investment banking arm of Société Générale. More than half of those surveyed said they were confident about the overall business conditions for the coming year, with only a tiny minority saying they were very concerned by the economic landscape.

The principal challenges facing finance directors include perceived governance over-regulation to underfunded pension schemes to the role of hedge funds. Most respondents welcomed governance codes of practice, though more than a quarter said that such codes had a negative impact on setting board-level remuneration, while 15 per cent said the same about audit quality.

More than half of finance directors said that pension fund deficits were having a negative impact on the company's balance sheet, though there was little consensus as to how the problem of underfunded schemes should be solved.

Key findings of the research include:

- The biggest perceived risk is a slowdown in demand growth, followed by restrictive regulation.
- Investor relations is the most time-consuming activity for CFOs.
- Sixty-four per cent of CFOs see pension deficits as a significant obstacle to M&A.
- Companies are generally getting more involved in the management of their pension schemes.
- Many companies concede that they were partly to blame for deficits by decreasing contributions in the 1990s.
- Forty-one per cent are worried by the growing influence of hedge funds as shareholders.
- The majority of CFOs (64 per cent) feel investor activists are driven by short-term interests rather than creating long-term value at the company.
- There is an even split between companies that have seen a positive and negative impact of IFRS.
- One in four companies has recently changed, or is considering changing, its auditor.
- The majority of companies have taken advantage of favourable market conditions to issue or refinance debt over the past year.
- M&A is expected to be a bigger focus over the coming year.

[www.financialnews.com](http://www.financialnews.com) 

## International Audit Regulators' Roundtable

The Financial Reporting Council has hosted a roundtable of 13 independent audit regulators from around the world at which they discussed arrangements for future mutual co-operation and reviewed issues of common concern.

Also represented at the meeting were international organisations already engaged in discussion of auditing issues including the Financial Stability Forum, the World Bank, the International Organisation of Securities Commissions (IOSCO), the Basel Committee, the Public Interest Oversight Board (PIOB) and the European Commission.

Issues discussed included progress in establishing audit regulators independent of the accountancy profession,

arrangements for cross-border exchange of information, concentration in the audit market, issues related to the independence of auditors and issues raised by the multi-jurisdictional structure both of audit firms and the entities they audit.

There was broad support for the concept of an appropriate international forum of independent audit regulators to facilitate co-operation amongst the national audit regulators. Proposals for an appropriate forum will be prepared for consideration at the next meeting of the regulators to be hosted in Australia in March 2006 by the Australian Securities and Investments Commission (ASIC).

[www.frc.org.uk](http://www.frc.org.uk) 

# Tales of pride a

**Tracy Long** summarises changing attitudes to UK board evaluation during 2005.

Since Cadbury's first Report in 1992<sup>1</sup>, corporate compliance, performance pressures and visibility levels on boards of directors have escalated, and boards of directors have found themselves facing unfamiliar issues. Boards are required to understand and interpret the strategic implications of the changing international marketplace, and provide leadership to ensure survival and success, combining a high level of stewardship and oversight of management whilst providing specialist expertise. Board responsibilities have widened from meeting basic legal obligations to proving a capability and competence which advances corporate objectives, embracing a variety of responsibilities including strategic development, financial and audit control, legal and ethical standards, and the prevention and management of crises.

In order to add value, boards are expected to regularly review their architecture and composition to ensure that it is appropriate for the current and future needs of the business, and prove to shareholders and other stakeholders that there is an ability, and a willingness, to incorporate necessary change at board level, increasing the chances of achieving corporate ambition and long-term shareholder value. The debate has gradually expanded from its original focus on the satisfaction of shareholders and regulators to include the concerns of other constituencies such as customers, employees and the wider community. Consequently boards of directors are, and will be, facing new challenges in the 21st Century, challenges which demand a greater understanding of technological advances, social pressures and international competitiveness.

In order specifically to address this issue, and emphasise the value of boards as a source of competitive advantage, the Combined Code, published in 2003, stated that the board should undertake annually "a formal and rigorous evaluation of its own performance, that of the committees and individual directors"<sup>2</sup>, a suggestion which appears throughout the Code.

## **Fears and criticisms**

However, although the implementation of the Code has enabled listed companies to have consistency of structure and operations, and transparency and visibility of best practices, critics argue that it has also created a level of bureaucracy which, apart from cost and time implications, emphasises the role of the policeman and bureaucrat rather than the strategic advisor. Boards have been slow to adopt recommendations regarding evaluation, arguing that there is insufficient evidence regarding the value, role and contribution inherent in any perceived link between board evaluation and effectiveness. Furthermore, it has been suggested that in an effort to

simplify the complex relationships between corporate governance, board effectiveness and organisational performance, evaluation measurements have been limited to the more simplistic and readily identifiable aspects of board performance, such as proportion of outside directors and attendance of meetings<sup>3</sup>, ignoring complex concepts such as the calibre of directors, their commercial acumen, ethics, and strategic ability.

It appears that many boards remain either unprepared or unconvinced of the benefits gained from boardroom evaluation, apprehensive of the difficulties concerning independent judgement, the ability to benchmark, transparency and clarity of process, personal bias and existing sensitivities. Potential benefits such as improved leadership and teamwork, clarity of roles and responsibilities, improved accountability and decision-making, and enhanced communication and operations are countered with fears concerning operational disruption, dislocated teamwork, and individual humiliation and exposure. Critics suggest that individual assessment is vulnerable to inappropriate interpretation, causing embarrassment for senior directors who have not previously been subjected to performance appraisals. Others fear that evaluation opens a Pandora's box, giving undue influence to corporate politics, as well as exposing directors to potential legal liability through disclosure. Evaluations are accused of being process orientated and time consuming; chairmen and company secretaries rarely have the time or specialised knowledge to conduct evaluation processes effectively, and are thus less able to facilitate an improvement in individual and group dynamics. Outsiders, who may be more independent, objective and knowledgeable, are treated with suspicion.

There is some foundation for these arguments. Boards have unique requirements and competencies, responding to the diverse demands of stakeholders, economic cycles, maturity levels, operational issues and locations. Furthermore, there have been a variety of complex roles identified in the literature for executive and non-executive directors which do not fit tidily into an evaluation template or measurement scale. Recent research revealed four major corporate influences - corporate lifecycle, structure, culture and processes - and a variety of dominant environmental factors, on boards roles which influence the ways that members allocate time and resources, identify their individual roles and contribution levels, and manage boardroom coalitions and conflict<sup>4</sup>.

However, there are a range of benefits beyond pure compliance for boards which are determined to maximise value. Boards that have embraced the link between board effectiveness and corporate

# and prejudice

performance are reflecting modern shareholder concerns and beliefs<sup>5</sup>. Boards that dedicate time and resources to the evaluation process can gain high quality information about substance rather than process, as well as demonstrating to themselves, their shareholders and other stakeholders a standard of excellence and strength of leadership<sup>6</sup>. Furthermore, board meeting schedules and agendas, which are often dictated by current issues and concerns, do not normally allow members the opportunity to question approach and expectation of important issues such as the quality of meetings, the composition of the board, the role of the directors and the relationships between members, management and shareholders.

The real benefits rely on an independent and objective evaluation process which accurately reflects the evolving and connected influences of lifecycle, corporate structures, board cultures and established processes, and interprets the unique dominant factors in each case which affect the decision-making process at board level. For example lifecycle, which determines internal and external access to resources, corporate stability, history and culture, and levels of business complexity, can influence board requirements, and the combination of general and/or specific expertise. The influences of corporate structure may include board size, contracts and tenure, and pressures from external visibility, peer pressure, and reputational risk. Corporate culture, levels of power and authority, and the nature of team working will also determine board effectiveness, deserving special attention in the evaluation process. Lastly, established corporate processes, such as meeting structures and agendas, information flows between members, and the use of shareholder communication channels such as the AGM and the Annual Report, will influence the decision-making environment, boardroom dynamics and leadership styles.

Furthermore, evaluation processes do not have to single out individual directors in an uncomfortable fashion; they can operate as a legitimised discussion of board issues, concentrating on board dynamics as a whole. The evaluation process and its participants can vary in intensity and method from year to year, incorporating changes to the dominant influences outlined above, and individually determined by specific objectives and cultural sensitivities. New members may find the evaluation process helpful in revealing the intricacies of approach and expectation regarding board process, and the level on consensus regarding the value of special items such as the strategic away-day and the induction process, whilst more established members may use the evaluation to comment on agenda issues, the accuracy and timeliness of minutes, and the standards of accountability and board operations.

## Conclusion

Corporate governance guidance has often adopted a Darwinian view; firms survive because they have optimal governance structures, and diminish because they fail to adapt to the changing environment and requirements. However, board performance is dependent on behavioural dynamics and the relationships between executive and non-executive directors; the depth and value of these relationships depends on the conduct of the individuals, and it is this conduct which is at the heart of board effectiveness.

The development of effective evaluation is critical to the ongoing effort to improve board performance and satisfy shareholder concerns. The calibre of disclosure to shareholders and other stakeholders, and the timely manner in which boards and shareholders act on evaluation outcomes, is under scrutiny. Boards of directors require more than a template and checklist approach, which appears increasingly insensitive to board culture and challenges, and is incapable of measuring complex configurations. Furthermore, it is the shared responsibility of shareholders, stakeholders, and other board members to encourage an evaluation process which reflects its integrity of purpose, and dramatically increases the levels of information, knowledge and power which support board members in their quest for excellence.

*Dr Tracy Long is the founder of Boardroom Review, a specialised consultancy for board evaluation and corporate governance across PLC, privately owned and public sector organisations. She serves as a non-executive director and trustee on a number of boards including Lowland plc and Nesta (National Endowment of Science, Technology and the Arts). Address for correspondence: 11 Horbury Mews, London W11 3NL; Tel: 07767 475 641; Fax: 020 7727 0779; E-mail: boardroomreview@aol.com* 

## Footnotes

<sup>1</sup> Cadbury. (1992). *Report of the Committee on the Financial Aspects of Corporate Governance*. London: Gee.

<sup>2</sup> Financial Reporting Council. (2003). *The Combined Code on Corporate Governance*. London: Financial Reporting Council.

<sup>3</sup> Cadbury, A. (1997). *Corporate Governance: An Update on Critical Issues*. *SES Journal*, August.

<sup>4</sup> Long, T.E. (2004). *The Role of the Non-Executive Director: An Empirical Investigation into the Differences between Listed and Unlisted UK Boards*. London: Henley Management College.

<sup>5</sup> Hermes. (2002). *The Hermes Principles: What Shareholders expect of Public Companies - And what Companies should expect of their Investors*. London: Hermes Pension Management.

<sup>6</sup> Kiel, G.C., Nicholson, G.J. and Barclay, M.A. (2004). *Board, Director and CEO Evaluation*. NSW, Australia: McGraw Hill.

# Pension provision

Executive pensions provision is complex and coming under increased scrutiny. **Paul Jayson** sets out the basic considerations.

There has been a huge sea-change over the last 15-20 years in the way pension benefits are delivered to senior executives. Once one of the easiest elements of a senior executive's benefit package, to construct, pension provision is now often a costly and complicated issue for an employer and a source of disappointment to the employee.

The pension aspirations of a new executive joining a company are generally to achieve a package of benefits equivalent to that which their predecessor will start to enjoy in retirement. Under the current tax regime, due to change next year, this will typically be a pension of two-thirds of their final salary, part of which can be taken as a one-off tax-free cash sum of up to 50 per cent more than their final salary. The pension will be inflation proofed and on death there will be a generous pension paid to a surviving spouse. Historically, an employer signed up a new executive for membership of its tax-approved pension scheme automatically, rarely giving a second thought about associated costs.

This model of defined benefit (DB) provision was common until the culmination of a number of events led to defined contribution (DC) being a more natural choice for an employer to offer.

## The steps to DB's demise

The gradual erosion of DB provision has come about from the toxic mix of a reduction in the level of benefits that can be provided in a tax efficient manner and an increase in the costs, both perceived and actual, of providing generous DB pensions.

## Reduction in tax efficient benefits

In 1987, the minimum period of service for entitlement to a full two-thirds pension increased from 10 to 20 years for new entrants to an employer's scheme. The rate at which maximum pension could be earned for older members was thereby greatly reduced. Then, in 1989, the final salary on which maximum benefits could be based was made subject to an 'earnings cap'. This cap started at £60,000 and is now £105,600. Taken together, these changes significantly reduced the potential to provide many executives with large benefits in a tax efficient manner at retirement. In addition, the impact of

the earnings cap was felt on the level of life cover (four times earnings) that could be provided on death in service.

A typical reaction was to by-pass these changes and offer 'top up' benefits to executives via an unapproved arrangement. An Unfunded Unapproved Retirement Benefits Scheme (UURBS) is merely a promise to provide an employee with benefits in due course. No money is put aside for this - although there will generally be a reserve held on the employer's balance sheet - and an element of trust is required from the employee that the employer will be in a position to meet its obligation in due course. A more secure version of this is a Funded Unapproved Retirement Benefit Scheme (FURBS) where the employer physically passes over money to a separate trust to provide the top-up.

UURBS and FURBS are taxed in different ways, both from the point of view of the employer and the employee. The employer does not enjoy any tax relief on the benefit provided to the employee via an UURBS until it is actually paid. On the other hand, a FURBS contribution is relievable against profits in the year in which it is paid. For an employee, however, a FURBS contribution attracts tax as a benefit in kind - although the employer may choose to provide additional remuneration to pay the tax.

If the FURBS trust deed is suitably constituted it should be possible to pay the benefit to the employee with no further tax. Benefits paid under an UURBS, however, are taxable on the employee.

## The cost issue

Whilst the tax authorities were gradually making it less tax efficient to provide executives with large retirement benefit packages, disclosure requirements were making their cost much more visible to shareholders.

Listed companies have to show the level of directors' pensions earned to date in their accounts, together with any real increase in these figures over the year. They must also provide sufficient information to estimate the capital cost of this real increase. This is highly visible and a remuneration committee will be well aware that shareholders will be scrutinising the figures.

n

These figures are shown quite separately from the normal pension costs and reserves disclosed in a company's accounts under accounting standards FRS17 or IAS19. Although the accounting figures relate to the pension scheme as a whole, the pension benefits granted to a relatively small number of highly paid employees entitled to a generous scale of benefits can form a significant part of the overall pension expense.

Apart from disclosure issues, the actual cost of funding benefits needs to be considered. The funding required to provide a given level of pension in retirement has soared in recent years. Two of the main effects are:

1. The low interest and inflation rate environment - higher contributions are needed if you cannot rely on rapid growth on funds from investment.
2. Mortality experience - the unprecedented improvement in life expectancy and the prospect of this continuing, possibly at a faster pace, have led to upward revision of the expected pension payment period.

We recently prepared a projection of the cost of providing a pension of one-thirtieth of final salary on retirement at age 60 to a 45-year old executive who had joined a company three years ago. The approximate amount required as an annual contribution over the period to retirement was 100 per cent of salary. Whilst this cost takes account of a number of features, such as the three-year catch-up, his relatively short period to retirement and imminent changes to the pension tax regime (of which more later) it does highlight the large amounts that can be required to meet executives' expectations.

### **Shifting sands**

The move from DB to DC pension provision is leading to a generation of haves and have nots in terms of benefits. The DB generation have feathered their nests and can look forward to a comfortable retirement - barring anything going wrong like the employer being insolvent and unable to fund their scheme. Even then, the new Pension Protection Fund will probably take over responsibility for some of the promised benefits.

On the other hand, the DC kids are having to make do with much lower benefits. Typical contributions to a DC scheme

might be 7-10 per cent of salary for ordinary members with executives entitled to higher contributions of say 10-15 per cent of salary. In most cases this is still well below the amount required to produce historical DB pension promises.

### **Changes to the pension tax regime - 'simplification'**

Simplification is the misleading tag line given to the radical changes being introduced to the tax regime within which UK pension schemes operate. These changes are scheduled to take effect from 6 April 2006 ('A-Day').

Whereas the changes discussed earlier reduced the maximum benefits that could be paid from a tax approved scheme, those limits will be abolished after A-Day. Instead, each individual will have a set of tax allowances within which they can earn and receive pension benefits under the most favourable tax privileges. Tax payments will be triggered if these allowances are exceeded.

The Annual Allowance is the maximum tax-free annual increase that can be applied to a member's accrued benefits (in a DB scheme) or the maximum tax-free annual contribution that can be paid (to a DC scheme) by and on behalf of the member - with a further restriction on the amount of fully tax relievable contributions that can be paid by the member.

Individuals will also be subject to a Lifetime Allowance. Essentially, benefits up to the value of the Lifetime Allowance will enjoy the most favourable tax treatment when they are drawn.

In theory this will make it much easier to provide pension benefits to an executive. An employer will no longer have to find ways to avoid maximum limits as these will not exist. In practice, however, executives will look to their employer to compensate them for any tax charges that they will suffer. In addition, the employer may not wish to see value eroded through tax. Those with legacy promises formulated before the advent of simplification may also have to be compensated for any additional tax which might be payable if they have contractual rights to receive certain benefits.

A thorough review of an executive's existing arrangements should be made in the run up to simplification to ascertain

Please complete this form and send by fax or mail to:

**Subscriptions Department  
Governance Publishing and  
Information Services Ltd**

Watchfield House, Watchfield,  
Highbridge, Somerset TA9 4RD, UK

Tel: +44 (0) 1278 793300

Fax: +44 (0) 1278 783750

Email: [info@governance.co.uk](mailto:info@governance.co.uk)

[www.governance.co.uk](http://www.governance.co.uk)



(Please tick one)

**Yes!** I would like to subscribe to **Governance** for one year

**Or, save with a 2 year subscription**

**Governance international  
subscription costs**

	£UK	Euro	US\$
1YR	275	430	545
2YR	495	750	955

*Governance can accept cheques in other currencies but an administration fee of £15 will be charged.*

I enclose a cheque/bankers draft for

Currency value

Please invoice me

Specify currency

Order reference

Title

First name

Surname

Position

Company/Organisation

Address

Postcode

Email

Tel:

Fax:

Continued from page 11

whether they will be affected as a result of the tax changes. For example, it is unlikely that future FURBS contributions will be advisable. It may also be worth taking advantage of the ability to amalgamate any UURBS arrangements into a registered scheme without testing against the tax allowances. After the review it should be possible to negotiate a strategy that takes account of both the executive's and the employer's position.

### Conclusion

There are various other factors that will be relevant in creating a suitable pension package for a senior executive. These include their own personal circumstances (whether they are married and/or have other resources on which to rely in retirement), their attitude to risk and the approach taken by competitors in the industry.

Many employers are now throwing up their hands and saying that pension planning for executives is too hard. The solution for many is to provide a core pension offering with additional cash compensation for the employee to use as they wish.

What is true is that the once gold standard pension arrangements offered to senior executives are on the wane and being replaced by cash payments, flexible benefit arrangements and long-term incentive plans. Pensions - down, but not quite out!

*Paul Jayson is Head of Actuarial Consulting & Benefits at Higham Group  
[www.highamgroup.com](http://www.highamgroup.com)*

## What our subscribers say...

"*Governance* is a useful means of keeping up to date on developments in a field which is assuming greater importance by the day."

"*Governance* is an admirable way of keeping in touch with corporate governance developments worldwide."

### INDEX

Organisations		People		Companies	
ABI	3, 5	PIOB	7	Karina Litvack	6
ASIC	6	World Bank	4, 7	Tracy Long	8
Basel Committee	7	Eric Anstee	3	Charles McCreedy	4
Deutsche Börse	5	Dr Gerhard Cromme	5	Peter Montagnon	3
ETUC	4	Martin Eadon	6	Deloitte	6
Financial Reporting Council	7	Jella Benner-Heinacher	5	F&C Asset Management	6
Financial Stability Forum	7	Reiner Hoffman	4	KPMG	3
FSA	3	Paul Jayson	10	Richard Davies	7
ICAEW	3	Neil Lerner	3	Investor Relations	7
IOSCO	7			Société Générale	7