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THE PUBLIC SECTOR UNDER EXAMINATION

PENSIONS INNOVATION

THE GROWING USE OF CONTINGENT ASSETS

COMPANIES ACT 2006

IMMINENT ISSUES FOR FINANCE DIRECTORS

FINANCIAL ACUMEN

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THE FINANCE & MANAGEMENT FACULTY

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FROM THE FACULTY

TESTING THE PUBLIC SECTOR

We have noticed over the last few months some interesting media references to performance measurement in the public sector. In the *Sunday Times,* government targets were blamed for distorting police priorities and making them less effective at fighting crime. On the Radio 4 *Today* programme some teachers were criticised for improper activities to improve pupils' grades because of pressure to deliver better results. Similar stories about the National Health Service have been in the news.

Behind all these stories is the implication that we want police to fight crime and teachers to educate children, but that performance measures are driving dysfunctional behaviour. There is a tension between process and results; and a focus on key performance indicators (KPIs) can cause processes to be distorted. Some would argue that this is because the KPIs have not been properly thought out. Others question whether we should have them at all.

The private sector has much greater clarity in setting KPIs because financial results are invariably the ultimate outcome. The public sector has less clearly defined objectives, which makes the setting of clear KPIs more difficult; however, as a consequence it may now be better at measuring non-financial indicators than the private sector.

We see private sector disciplines being introduced into the public sector. We suspect the private sector may also have something to learn from the public sector. This criticism of the public sector is perhaps because they are under more public scrutiny. There are probably plenty of examples of poorly set KPIs in the private sector which are unknown outside the business in the short-term. In this issue of *F&M* we have two articles on this topical subject.

CHRIS JACKSON and EMMA RIDDELL

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PENSIONS – THE GROWING USE OF CONTINGENT ASSETS

Pensions deficits have preoccupied companies in recent years, but boards are now beginning to feel concerned about future 'trapped' surpluses. **Marc Hommel** and **Louise Inward** explain how contingent assets can be used to fund pensions while avoiding that potential problem.

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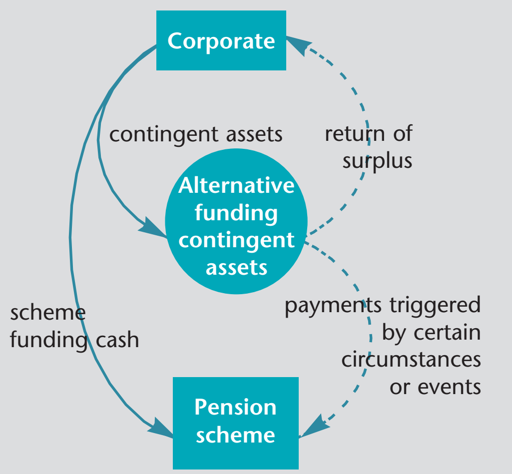
PwC was recently named 'pensions and benefits consultancy of the year' in the 2007 pensions awards organised by Professional Pensions journal.

Boardroom attention to pensions in recent years has been dominated by the impact of pension scheme deficits together with the way increasing trustee powers affect the sponsoring employer's ability to conduct business as usual. Yet boards are now becoming concerned about the possible emergence of 'trapped' surpluses. Many companies fear they are being asked by trustees to put too much money into pension schemes (as a result of new scheme funding requirements) when the cash can be better used elsewhere.

Increasingly, therefore, companies are seeking alternative funding mechanisms that enable the sponsor to keep control while, at the same time, satisfying the funding needs of the scheme trustees and being acceptable to the Pensions Regulator (PR).

FIGURE 1: ALTERNATIVES TO STRAIGHT CASH FUNDING



PricewaterhouseCoopers LLP

Range of contingent assets

1 Guarantees
2 Letters of credit
3 Escrow accounts
4 Partnerships
5 Trusts
6 Insurance-based solutions (including captives)
7 Combination of above

Pension trustees are demanding more cash from their sponsoring employers. Under pressure from the PR, they are increasingly placing a prudently high valuation on pension scheme liabilities and looking to get any deficit against this measure paid off as quickly as possible. Strong employers, so the argument runs, should be in a position to pay in higher amounts of cash: in the same way, weaker employers should be asked for more to avoid the risk of future non-payment. Many employers are concerned that growing cash demands are such that, should investment conditions be favourable, today's pension deficits could in fact quickly become tomorrow's surpluses. Surpluses are difficult for employers to recover, and any recovery is subject to punitive tax.

There is growing evidence that trustees are increasingly using Financial Reporting Standard 17 (FRS17) or International Accounting Standard 19 (IAS19) as funding targets – the new 'minimum funding accident' if you like. They worry that the PR will interpret their use of any lower funding target as breaking one of its triggers for further investigation, notwithstanding that this is clearly not what the regulator intends. The accounting standard assumes that future investment returns on pension assets will be those assumed by long-dated corporate bond yields. To the extent that actual investment performance exceeds this, surplus will result.

Companies are increasingly interested in using alternatives-to-direct-cash funding to meet their pension funding commitments. A growing range of solutions is becoming available: solutions that enable the company to retain control while also satisfying the trustees' funding requirements.

Figure 1 (left) shows how contingent assets can fit between the employer and pension scheme. A contingent asset is an asset in which the possibility of an economic benefit depends solely upon future events ('triggers') that cannot be controlled by the recipient – the pension scheme. A very common trigger is the insolvency of the company. Not only can contingent assets be used to avoid trapped surpluses, there are potentially other benefits too.

For employers, the benefits of using contingent assets include:

- reduced levy payment to the pension protection fund (PPF);
- improved control of cashflows;
- opportunities to improve return of corporate capital;
- ability to make use of existing company assets, for example property; and
- flexibility to implement an investment strategy aligned with the company's risk appetite, where this differs from the investment strategy adopted by the scheme's trustees.

For trustees, the benefits of using contingent assets could include:

- improved security relative to the other options on offer;
- improved relationships with the scheme's sponsor;
- greater flexibility to rebalance or de-risk the investment strategy; and
- improved covenant of the sponsoring employer.

Pension trustees are demanding more cash in schemes

Criteria for choosing the appropriate solution
Companies wishing to implement contingent funding solutions need to consider the merits and demerits of each option. The challenges of finding solutions acceptable to all stakeholders are complex and need careful consideration.

Nonetheless, the favourable impact for both corporate sponsors and trustees of adopting such creative solutions can be quite dramatic, especially if combined with an integrated strategy for reducing the deficit and de-risking the investment strategy.

With a range of contingent solutions available, it is critical that the company is clear about the purpose of using contingent assets in determining the criteria against which to assess the appropriate outcome. The criteria, which need to be ranked, typically include:

- extent of control of investment strategy;
- extent of alignment with corporate risk appetite;
- ability to avoid or access any emerging surplus;
- flexibility to use existing corporate assets (such as property), consistent with self-investment restrictions;
- timing of cash flows and tax (both on initial contributions and the investment returns);
- trustee alignment (risk sharing appetite/employer covenant/scheme funding position);
- the view of the PR;
- the impact on the Pension Protection Fund (PPF) levy; and
- the impact on accounts (balance sheet and P&L).

PwC's latest pensions survey shows that 8% of employers have already put contingent funding in place – with another 16% considering doing so in the next 12 months. It will be interesting to monitor how the use and appeal of contingent assets develops in the foreseeable future.

Case study
In the following example of a trust meeting all the above criteria has been used as a contingent funding solution.

The trustees and Company X agreed a scheme specific funding objective at around the same level as under FRS 17, meaning a deficit of £100m. Although the company had cash available to fund the deficit rapidly, it wanted to use those funds to acquire an additional business which would have the additional benefit of strengthening its covenant.

The company was also concerned that rapid cash payments into the scheme might lead to the scheme being in its view, overfunded, and believed that it could in fact get a better return for the cash by purchasing an additional business. The company had significant property assets and came to an agreement with the scheme trustees to put £100m worth of property into a separate trust for the benefit of the pension scheme – 'the reservoir'.

The terms of the reservoir trust were such that if, at the end of the recovery period of 12 years, the pension scheme deficit was not paid off, the assets of the reservoir would be transferred to the pension scheme. If at any valuation the combined assets of the pension scheme and the reservoir were above the scheme funding objective, then assets might be returned from the reservoir to the company.

The trustees were happy with the proposal as it gave them additional security. It also improved their relationship with the company, which perceived the trustees as being willing to help them grow the business. **F&M**

FACULTY WEB LINKS

- 'Pensions – the role of finance' – SR14
  www.icaew.com/index.cfm?route=143280

PUBLIC SECTOR

GETTING AWAY FROM 'CULTURAL CRINGE'

The public sector's finance and management skills are widely regarded as inferior to those practised by private sector companies. But is that view well-founded? In the following two comment pieces, leading academic **Sir Andrew Likierman** (author of the first article, below) and public sector insider **Mel Zuydam** (author of the second, see page 7) argue that a reassessment is due.

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'Cultural cringe', for those who haven't come across it, is defined as an internalised inferiority complex which causes people in a country to dismiss their own culture as inferior to the cultures of other countries. Substitute a few words in the definition and we have a pretty good description of the public sector's attitude to most of its own management practices: there is an almost complete public sector consensus that the private sector is superior, and that the transfer of knowledge and people can only be one way.

Unfortunately, most of those in the private sector tend to agree – feeling that if only public sector departments were managed like General Electric, Toyota or BP, the public would be much better off.

Yet all well-managed organisations, public or private, know they could do even better. And there are many instances where the public sector has a lot to show private sector companies – a glaring example being that of effective performance measurement.

Public sector performance management

In many areas of performance measurement the public sector is ahead of the private, for reasons including:

- the need to reconcile rising demand for services with declining taxpayer willingness to pay for them;
- the demand for public accountability; and
- the absence of a clear 'bottom line'.

Together these factors provide a big incentive to do better.

Government 'targets' are reviled but provide a comprehensive set of performance measures

Take the example of public service agreements for central government departments. Although much reviled as 'targets', these nevertheless provide a much more comprehensive set of performance measures than are generally found in private sector organisations, where the layer of non-financial measures supporting profit and cash is often patchy and inadequate. Despite the constant references of ministers to how much money is being spent, they also increasingly focus on outputs and outcomes. By contrast, much measurement in the private sector still focuses on activity and inputs.

Or consider comparisons between local authorities and health authorities. These are much more sophisticated than the half-hearted attempts of many private sector organisations to benchmark themselves. Of course there are many authorities for comparison purposes. There is also the advantage that figures are not commercially sensitive. But it is the quality of the analysis that marks them out.

Benchmarking best practice

Take the 2006 benchmarking study of the government estate by the Office of Government Commerce. This provides effectiveness results for buildings on a number of criteria. The study is notable for a number of elements of good practice:

- involvement of the participants;
- use of a pilot study;
- sophistication without undue complexity;
- usable results; and
- follow up.

Few private sector organisations take this kind of trouble, even though there are major economic incentives for them to do so. Indeed not enough seek out comparisons of this kind for lower-level activities where benchmarking detail is less sensitive to issues of commercial confidentiality – such as response time for queries by service functions.

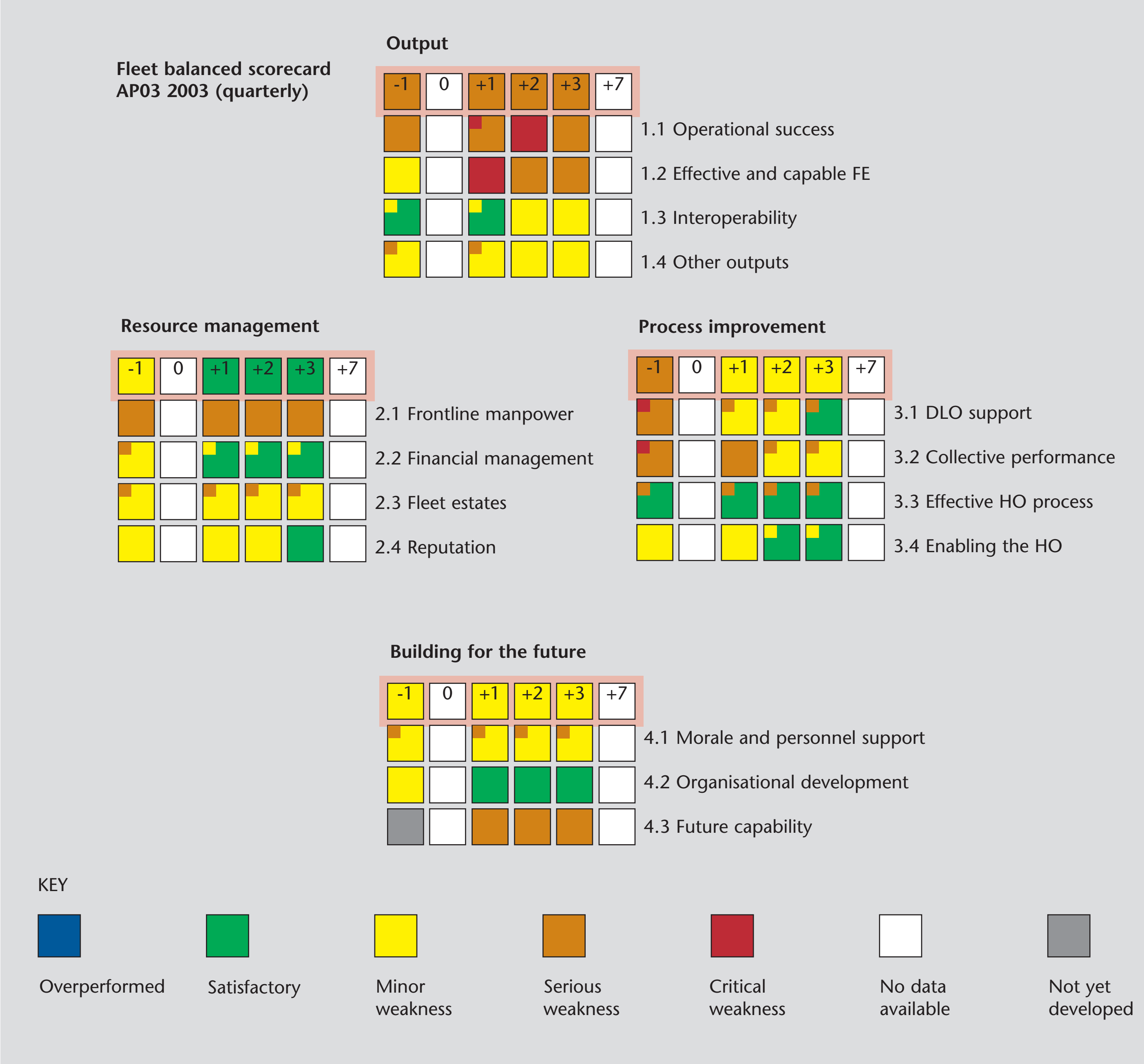
Balanced scorecard

At this detailed level, there are many examples of good practice. The Ministry of Defence's balanced scorecard (measuring output, process improvement, resource management, and building for the future) is tailored to the specific requirements of defence (see Figure 1, below). It uses a run of quarterly figures – two of the columns being backwards-looking (ie showing performance in the last quarter and the current period), and three showing the next three quarters' predictions. A red sign in the corner (not illustrated) identifies critical elements within any square so that a good overall rating does not conceal a major problem. The scorecard has been in active use and refined over a number of years. By contrast, most private sector balanced scorecards are poorly targeted and poorly used.

Reporting

Finally, there's the question of reporting performance. The public sector is miles ahead of the private sector in this respect. The argument that this is because the private sector has to maintain confidentiality is not really convincing, since the complaint of many quoted companies is that the market does not understand them. Better reporting of measures is essential to bridging that gap in understanding – something that the operating and financial review (regrettably never adopted as a statutory reporting requirement) was designed to help remedy.

FIGURE 1: THE MINISTRY OF DEFENCE'S BALANCED SCORECARD APPLICATION FOR ITS FLEET



Don't write off the public sector
This is not to argue that everything in the public sector is better. There are plenty of examples of things going wrong, of perverse incentives and dysfunctional behaviour. But it is short-sighted of those in the private sector to assume that they have the monopoly on wisdom. If the definition of a well-managed organisation is one that is always prepared to learn, writing off the public sector as a possible source of good practice – particularly for performance measurement – is a mistake. **F&M**

HOW THE PUBLIC SECTOR IS RAISING ITS GAME

Here **Mel Zuydam** suggests that the public and private sectors are complementary, not in competition.

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Until quite recently, government finance and budgeting comprised cash accounting, with the concept of an accrual being somewhat alien to many. But now, just as the government's 'professional skills for government' initiative is encouraging professionalism in all aspects of leadership, so the public sector finance function is also being transformed. Mary Keegan, head of government finance profession at the Treasury, is championing the adoption of private sector disciplines.

However, in assessing the relative strengths of the private and public sectors it is important to note that we are not comparing like with like. The public and private sectors carry out very different roles: the public sector is typically the client, while the private sector is the supplier. And the skills required for spending money effectively are different from those required to generate it.

The public sector's major shift
I would argue that the public sector is already very strong in areas such as sustainability, transparency and propriety. But it is currently also undergoing a major shift, moving towards a culture where trying to generate funds – whether through greater efficiency or through innovative private sector partnering – is the norm rather than the exception. From now on, spending money must be done with the intent of maximising the return to taxpayers, while also building a strategic informed and transparent supply chain culture (as opposed to an adversarial one).

With its enormous expenditure – £440bn for 2005/6; equivalent to one third of UK gross domestic product – the public sector needs to extend the skills of its finance teams to enable successful delivery in this new more demanding culture. Hence, under its adoption of the more exacting practice of resource accounting, changes are now taking place, namely:

- the public sector's old bespoke accounting systems are being replaced by shared service enterprise resource planning (ERP) systems*;
- the supply chain is becoming global;
- supply chain relationships are becoming strategic and more complex (often involving private finance initiative [PFI], public/private partnership [PPP] and other forms of partnership and risk sharing); and
- the demand for accurate, timely and useful financial management information to drive effective performance management, investment decisions and efficiency has never been higher.

No wonder, then, that departments now have fully qualified finance directors on their boards, finance is one of the four core skills under the 'professional skills

From now on, spending money must be done with the intent of maximising the return to taxpayers while building a supply chain culture

* Integrated business IT systems which seamlessly combine human resources, financial management plus budgeting, planning and scenario modelling functionality.

for government' framework, and there is a continued drive to build further on commercial and corporate finance skills.

Public/private sector common thread

Despite the two sectors' above mentioned different functions, the evolving demands of private and public sector financial management have a common thread – namely risk, its effective identification and mitigation, and the consequential organisational appetite for it.

Over past decades the private sector has become increasingly involved with the delivery of public services, leading to the public/private trading relationships already noted. But nowadays, to boost value for money and effective delivery, and also to manage risk more effectively, the public sector needs to improve the financial and commercial skills base that it has in the front line – ie interfacing contractually with the private sector. And once the sector's finance and commercial skills have been 'upped', the best structure to achieve this improvement is a decentralised matrix structure in which the skilled front line staff are empowered to manage the risk directly.

This structure has the advantage of devolving, decentralising and empowering, while operating within an effective central framework. It also has the added advantages of putting financial and other corporate services functions out into the business and at the front line, breaking down 'silo' cultures and enabling clearer and more effective accountability. Many plcs operate on this basis, but the key remains the effective overarching controls framework, and this is equally relevant for a government department.

The way ahead

So what areas for improvement still remain? Looking at a theoretical balanced scorecard, the finance, internal processes, and learning and growth perspectives remain important.

But I would argue that for both public and private sectors the fourth classic balanced scorecard perspective, 'the customer' – including shareholders, investors, the myriad public sector stakeholders and of course the public itself – is the one that will increasingly lead the way. And the demands of that customer are changing through drivers such as significant demographic shift, climate change, security requirements, globalisation and a 24/7 culture.

In the future, therefore, it may be more constructive to stop making public-versus-private-sector comparisons and concentrate on how the two can most effectively use their respective skills-sets to complement one another and integrate both on front-end delivery and in the strategic context.

Rather than a competition, a partnership is what's needed – one that produces synergies through the complementary matching of skills and strengths, so that the whole is greater than the sum of the parts. **F&M**

BUSINESS FUNDING

CORPORATE DISCLOSURE AND THE COST OF CAPITAL

The views of finance directors

ICAEW REPORT

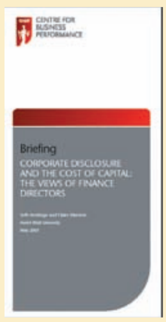
SURVEY FINDS NO CLEAR LINK

This project investigates the views of FDs on the costs and benefits of corporate communications, with a focus on their views about the link between disclosure and the cost of capital. The focus on the cost of capital is motivated by the emphasis in previous research on the cost of capital as a primary route – perhaps as the primary route – by which disclosure policy affects company value.

A feature of the findings is that opinions differ on most of the questions posed. At the risk of neglecting this diversity, the majority views are summarised below.

There are two main findings:

- the majority of the FDs do not believe that there is a clear link between disclosure and the cost of equity. Only one quarter believes, without qualification, that more disclosure reduces the cost of equity. A further quarter believes that this is so only up to the point at which a good practice level of disclosure has been reached. Nearly two-fifths perceive no link between disclosure and the cost of equity in practice, probably because their companies already provide at least a good practice level of disclosure; and
- the main benefits of communications are seen as promotion of confidence amongst investors and of a reputation for openness. Whilst these effects could result in a lower cost of equity, they are seen by FDs as ends in themselves. Of the FDs, 10 chose to describe the main benefit of corporate communications in terms of confidence, integrity, good citizenship or understanding. **F&M**



Briefing: Corporate disclosure and the cost of capital: the views of finance directors
Seth Armitage and Claire Marston, May 2007

Read more by downloading the briefing (free, 24pp, May 2007) – www.icaew.com/index.cfm?route=148608
For a printed copy please call +44 (0)20 920 8634.

COMPANY LAW

COMPANIES ACT 2006 – ISSUES FOR THE FD

The recent Company Law Update event focused on the Companies Act 2006. As **Kathryn Cearns** and **Carol Shutkever** outline below, some of its provisions are already in force, others come into play in October, and the remainder kick in from April or October 2008. Be prepared!

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Although the Companies Act 2006 (2006 Act) will impact on all aspects of corporate governance and reporting, below we focus on the principal areas which will be of interest to finance directors.

Timing
The 2006 Act comes into effect on staggered commencement dates until October 2008. A small number of provisions have already come into force (see list below). The three further planned commencement dates are 1 October 2007, 6 April 2008 and 1 October 2008 (see 'Your countdown' box, page 11).

Changes already in force
The provisions already introduced are:

- 1 January 2007 – Companies Act 1985 amendments implementing changes to the First Company Law Directive, so that company details must now be included on company emails and websites;
- 20 January 2007 – implementation of the Transparency Directive, the new regime for disclosure of interests in shares, the safe harbour for directors from liability in relation to narrative financial reporting, and new provisions on communications with shareholders; and
- 6 April 2007 – consolidation of the May 2006 implementation of the Takeover Directive, removal of the 70 year age limit for directors and removal of the requirements in section 324 of the 1985 Act for disclosure of directors' interests in shares (but with the Disclosure Rule requirements remaining for listed companies).

E-communications
The communications provisions in the 2006 Act give companies an ability to use electronic communications with shareholders as the default position. Companies can now place documents, such as annual reports and accounts, on a website rather than having to mail them to shareholders in hard copy. Shareholders have to opt-out of website communications rather than, as under the 1985 Act, opt-in. However, a notice of availability of the document on the website must still be sent if no email address has been given.

Companies can use electronic communications with shareholders

Transparency rules (listed companies only)
To implement the EU Transparency Directive, part VI of the Financial Services and Markets Act 2000 was amended by the 2006 Act to give the Financial Services Authority (FSA) powers to make transparency rules. These rules, in force since 20 January 2007, sit alongside the existing listing, prospectus and disclosure rules. They contain the requirements for the disclosure of periodic financial information and the provision of information to the market by listed companies. They also contain the requirements for disclosure of interests in voting rights in listed, Alternative Investment Market (AIM) and PLUS Markets Group (PMG) companies (replacing provisions in sections 198-211 of the 1985 Act).

The financial reporting aspects of these rules apply for accounting periods beginning on or after 20 January 2007.

Safe harbour for narrative reporting
The 2006 Act's safe harbour in respect of directors' liability for statements in the directors' report (and the remuneration report and summary financial statements derived from those reports) has been in force for all reports issued after 20 January 2007. This means a director will be liable only in relation to statements which are untrue or misleading and are made in bad faith or recklessly or when there is deliberate and dishonest concealment of material facts. Also, that liability is only to the company and not to any third party.

It may become the practice for all the narrative reporting aspects of the annual report, such as the chairman's statement, the chief executive's statement and any voluntary Operating and Financial Review (OFR), to be incorporated into, or referred to by cross-reference in, the directors' report, in order to try to take full advantage of the safe harbour.

Changes yet to come

Directors' duties
One of the most controversial aspects of the 2006 Act has been the provisions governing directors. The key development is the introduction of a statutory statement of directors' duties codifying the common law rules and equitable principles which presently govern the relationship between directors and their companies.

The 2006 Act sets out the following seven duties for directors:

- to act within the powers conferred by the company's constitution;
- to promote the success of the company for the benefit of its members;
- to exercise independent judgement;
- to exercise reasonable care, skill and diligence;
- to avoid conflicts of interest;
- not to accept benefits from third parties; and
- to declare any interest in a proposed transaction or arrangement with the company.

The first four of these duties come into force in October 2007 while the last three (which all relate to conflicts of interest) are coming into force in October 2008.

The duty to promote the success of the company requires a director to have regard to several factors, including the long-term impact of a decision, interests of employees, suppliers, customers and others, impact on the community, the environment and reputation, and the need to act fairly as among members of the company.

This duty encapsulates the concept of 'enlightened shareholder value' whereby the interests of stakeholders represent an important factor in whether a company is successful and should therefore be considered when making business decisions. It is important to remember, however, that the primary duty is still owed to the company itself, not other stakeholders.

The duty encapsulates the concept of 'enlightened shareholder value', where stakeholders are important

The duty has been heavily debated, amid fears of greater board meeting bureaucracy as directors create a paper-trail to show they have shown due regard to the factors. The key is to take a proportionate approach to each decision. It is not the case that the factors will need to be recited in all board minutes. Of greater importance will be ensuring that all directors are aware of the statutory statement of duties, that procedures and processes (for example, terms of reference for management committees) reflect the new formulation of the duty and that the company's corporate social responsibility statements and strategies are aligned with the factors.

Enhanced business review (quoted companies only)
The requirements in the 2006 Act for the directors' report to contain a business review applies to all companies, unless the company is subject to the small companies regime. This requirement takes effect from October 2007, for financial periods starting after then.

Under the 1985 Act companies are required to include a fair review of the company's business, which is a balanced and comprehensive analysis of development, performance and position, as well as a description of the principal risks and uncertainties.

The 2006 Act additionally requires quoted companies to disclose the main trends and factors likely to affect the future development, performance or position of the business, and provide information about environmental, employment, social and community issues, and 'essential' contractual relationships.

Organisations should treat their business review as a means of demonstrating compliance with the duty to promote the company's success, including how the stakeholder factors are addressed in line with the company's corporate social responsibility strategy.

Accounts and reports
The overall change in the 2006 Act is to switch to a 'think small first' approach in relation to accounts. The 2006 Act starts with the small companies regime and builds up to the requirements for the largest companies and groups. At the larger end there is also a distinction drawn between quoted and unquoted companies. These provisions are being brought into force in April 2008.

Much of the detail regarding contents of UK Generally Accepted Accounting Principles (GAAP) annual accounts, currently contained in schedules to the 1985 Act, has not been reproduced but instead will be in secondary legislation. Drafts of these regulations are now available on the website of the Department for Business Enterprise and Regulatory Reform (DBERR) – www.dberr.gov.uk.

Again, a 'think small first' approach has been followed, so that although the detailed rules have not been changed substantively, they have been restructured into a single set of accounting regulations for small companies and a single set for all other companies, so they should be easier for small companies and their advisers to follow.

YOUR COUNTDOWN TO FUTURE COMPANIES ACT 2006 COMPLIANCE

OCTOBER 2007

Directors' duties (except conflict of interest) in force

- Decide how compliance with the duties can fit with the company's approach to other compliance issues and its decision-making arrangements and processes.
- Educate the board on the new duties and have a discussion on them at a board meeting shortly before they come into force.
- Build the existence of the stakeholder factors into the company's corporate social responsibility strategy.
- Clarify with insurance brokers if any amendments are required to be made to policy wording of any directors' and officers' insurance.

Meetings and resolutions

- Ensure compliance with the new procedures and rules for company meetings and resolutions (including written ones).

Contents of directors' report – enhanced business review

- Quoted companies must include information on the main factors likely to affect the company's future business as well as details of suppliers which are essential to the business.
- To gain protection of the safe harbour (s463) from liability relating to information in the directors' report, as much information as possible should be in (or cross referred to in) this report.

APRIL 2008

Accounts and reports

- Shortening of deadlines for filing accounts needs to be taken into account by all companies.
- The new accounts contents requirements (set out in draft regulations) come into force for accounting years beginning on or after 6 April 2008.

Audit

- Companies, as well as auditors, will have notification duties when they change auditors before the end of an auditor's term of office.
- Limited liability agreements (LLAs) are likely to be pushed for by all the major audit firms. Any LLA entered into will have to be approved by shareholders each year.
- The requirements will apply to audits of accounts in respect of financial years beginning on or after 6 April 2008.

Share capital/capital maintenance

- Greater flexibility now allowed for intra-group transfers of assets.

OCTOBER 2008

Share capital/capital maintenance

- Companies can now take advantage of the removal of the prohibition on financial assistance for private companies and the new non-court reduction of capital procedure for private companies.
- New rules in relation to share capital, including redenomination of share capital and requirements for filing of a statement of capital.

Directors

- Company articles should include new provisions for dealing with conflicts of interest, including board authorisation.
- All companies must have at least one individual as a director (although the DBERR intends to allow an additional two-year grace period for companies that had no natural directors as at 8 November 2006), and all directors must be over 16.

Constitution

- Abolition of the memorandum of association as an operative document.
- Public and private companies should all consider adopting new articles with effect from 1 October 2008 to make them compliant with the 2006 Act, or to enable them to benefit from deregulatory provisions.
- New model articles become the default articles for new companies in place of Table A*.
- New rules on company names, including new rights to object to opportunistic registrations.

Administration

- All Companies House forms will be updated.
- New rules on company registers and records come into effect.
- New procedure starts for execution of documents, including execution of deeds with one director signing.

* Under the Companies Act 1985 s8, Table A is as prescribed by regulations made by the Secretary of State; and allows a company to adopt the whole or any part of Table A for its articles.

Other changes to be introduced by the 2006 Act include directors having a general obligation not to approve accounts unless they give a true and fair view of the financial position of the company, and shorter deadlines for filing accounts.

For private companies the period for filing reports and accounts is reduced to nine months (from 10) after the end of the relevant accounting period, with no need (unless required in a company's articles) for an AGM. For public companies the filing deadline is reduced to six months (from seven), with the AGM held within that period.

Audit

One of the more widely debated areas of change that will be introduced by the 2006 Act is that a company and its auditor will be able to enter into a liability limitation agreement (LLA), which can cover, in relation to a company's accounts, negligence, default, breach of duty and breach of trust on the part of the auditors. Both public and private companies will be able to authorise an LLA either before it is made, by an ordinary resolution approving its principal terms, or after it is signed, by an ordinary resolution approving the LLA itself. The LLA will have to be approved annually thereafter. These provisions will be in force from April 2008. The government has published a response to the consultation on Part 16 (Audit) of the Companies Act 2006 and draft regulations (both are available on the DBERR website) for the information that must be disclosed in relation to auditor remuneration and limitation of liability agreements.

The Financial Reporting Council (FRC) has appointed an independent working group, which is expected to issue guidance on the new provisions by end-2007.

Capital maintenance

From October 2008 the 2006 Act will bring into force a range of helpful deregulatory measures relating to capital maintenance. The prohibition on private companies giving financial assistance for the purchase of their own shares has been removed (although there are still some restrictions where there is a public company in the group).

Under the 2006 Act, a private company limited by shares will be able to reduce its share capital in any way by special resolution without court approval if the resolution is supported by a directors' solvency statement covering the next 12 months. There is still some uncertainty about the effects of this method on distributable reserves. However, we expect the final version of the draft statutory instruments on this subject to allow any reserve arising to be treated as realised (its distributability then being dependent on whether there are any losses brought forward or subject to any common law tests). Provided the company has distributable profits, a sale by the company of a non-cash asset at book value will not result in the company having made a distribution (dealing with the so-called *Aveling Barford* decision). This will be of particular help for intra-group transfers.

Other provisions

Although this article covers the headline issues for FDs, running a company will change more generally once the 2006 Act is fully in force. Procedures relating to meetings and resolutions will alter from this October (2007), memoranda and articles of association will need to be amended to reflect the 2006 Act and running private companies will become easier in some administrative respects.

The 2006 Act contains a lot to get to grips with, for directors, shareholders and lawyers alike. A lot of the detailed secondary legislation is appearing on the DBERR website now and those concerned with implementation of the Act should keep an eye on these developments. **F&M**

FACULTY WEB LINKS

- 'Companies Act 2006' – F&M special edition www.icaew.com/index.cfm?route=148125
- 'Companies Act 2006' – webcast www.icaew.com/index.cfm?route=149585
- 'Directors' duties' – F&M145 www.icaew.com/index.cfm?route=148617

LEADERS' VIEWPOINT

THE IMPORTANCE OF FINANCIAL ACUMEN IN STAFF

In this *F&M* series in which leading business figures discuss specific lessons derived from their experience, **Blythe McGarvie** reveals the benefits she gained from training staff in the language of finance.*

One of the things that I believe so strongly, down to my deepest parts of my heart, is you have to create financial acumen throughout your company. I don't care if you're in finance, marketing, or human resources – you have to understand what makes money for the company.

I became a chief financial officer in 1995 for a sleepy Maine supermarket retailer. We were known to be very progressive with our people, and we'd let people try different things, and that was good. But one of the things that I discovered in my first couple of months there was that the head of real estate was the person who also did all the analysis justifying the purchases of the different real estate locations.

I thought to myself, 'Well that's interesting. It's good that he's doing that because he understands how to make money for the company, but what's finance and accounting's role?' I found out they didn't have one, so I talked to the chief executive officer (CEO). I said, 'This is a little bit like letting the fox into the henhouse. You've got your real estate guy not only finding the sites, but justifying them and really, telling the world, this is what I think is going to make money for the company, and in eight years you might find out if it's true or not.'

So within a few months, my finance people started analysing the real estate investments. (And we would spend about $500m a year on real estate investments. This was not trivial.) The first thing we found out is that the real estate folks didn't have it right. They were combining the justification of purchasing the land with the financing decision, and anybody in finance will be the first to tell you, you have to separate those decisions. It was a good thing that we had become involved with the investment and financing decisions, because we also found a second problem.

What was being said in the assumptions and told to the board of directors was one number; what was put in the annual budget was a much lower number. We were using sales figures to justify our investments and

* This article is transcribed from 50Lessons' library of over 500 video lessons given by 100 business leaders. To view and hear the full interview online, visit www.50lessons.com.

Blythe McGarvie is senior fellow for the Kellogg Innovation Network.

CAREER MILESTONES

- McGarvie is a qualified certified public accountant with an MBA from Kellogg Graduate School of Management at Northwestern University. In 1992 she received the latter's Shaffner award – an honour given to alumni who are pre-eminent in their fields.
- From 1994 to 1999 she was senior vice-president and CFO of Hannaford Bros Co, the $3bn supermarket retailer subsequently bought by DelHaize Group.
- From 1999-2002 McGarvie was executive vice-president and CFO for the French group BIC, traded on the Paris Bourse.
- In 2003 she founded Leadership for International Finance, a consulting firm which focuses on improving its clients' financial positions.
- She has served on the boards of Accenture Ltd, The Pepsi Bottling Group, St Paul Travelers Insurance and Lafarge North America
- Recently McGarvie has shared her insights into the CFO role in her book *Fit in, stand out, mastering the FISO factor for success in business and life*, published by McGraw-Hill in 2005.
- She was recently appointed senior fellow for Northwestern University's Kellogg Innovation Network

IDEAS FOR ACTION

- Set up a day-long training session for all department heads. Bring in a trainer to discuss finance basics. At the end of each day, ask each department head to turn in a list of areas in which they have not been speaking the same financial language.
- After the training session, assign each department head the task of speaking with employees in their departments about financial acumen. Encourage them to use simpler language, for those employees who lack a background in finance.
- Assess current investments and profit figures against the current budget. Are the numbers the same? If not, what is the cause of the discrepancy? Initiate a plan to reconcile the numbers by the end of the next quarter.
- As a business manager, evaluate the financial reporting structure used by each department. If not consistent, assemble a team to identify which items need to be consistently reported, and then create and distribute templates so that during the next reporting period the financial results are accurate.
- For one month, send staff members a weekly electronic newsletter of tips to improve financial acumen. Include key terms and definitions, answers to frequently asked questions, and examples from real-world scenarios.

profit figures, and yet that's not what our budget showed, and our bonus was paid on our budget. This didn't make sense to me. If you're going to say one thing to one group, the board, it should be consistent, and you should hang your hat on your numbers. You don't just try and dress it up, put lipstick on a pig to make it look better. You have to take your investment, believe it, and then deliver. Results are important.

That was an important lesson in financial acuity, that the real estate folks learned, and the operations folks learned – because they were the ones running the supermarket, they had to make the sales and profit figures that were in our investment analysis – and all of us, at the headquarters, had to learn.

We learned that the assumptions in the model that was used for our investment decisions were not correct, but I knew the hearts of those involved were in the right place. So I went to my business school, Kellogg, and I had an investment finance professor come out. I hired him for two days, to train 150 people how to make investment decisions. It's not something you are just born with: these are skills that you can learn. By having this professor come and teach us capital investment theory, and walk us through a couple of cases, people started to learn – 'Oh, that's how depreciation hits my P&L', or 'So that's the kind of decision or assumption I have to make. I've been just giving any number because I thought that's what you wanted to hear…'

So we had much more integrity in our numbers, as a result of this training. We made better decisions, and another key lesson is, the more you can train people with financial acuity, the more you have ambassadors throughout your company. It's marvellous to be able to talk to a real estate person or a technology person – somebody who says, 'I know what you're talking about – Net Present Value. Okay, I even understand the concept. Now I know why you want me be so specific in my assumptions.'

It's so empowering to talk the same language, and finance is the language of business. I don't care what role you play in your company, your job is to help the company make money, and finance is the language that helps you communicate how you're going to make money for the company. **F&M**

LESSON SUMMARY

- For a company to be successful, every employee must understand what makes money for the company.
- When employees are not trained in financial acuity, poor business decisions are made.
- Financial acumen is a skill that can be learned and provides integrity in the numbers because everyone is using the same measuring stick.
- A company's financial message must be consistent among investors, management, and staff.
- Finance is the language of the business, and it enables people to communicate how they will make money for their business.

STRATEGIC PLANNING

STRATEGY MAPS – USEFUL TOOLS FOR FDs

Jonathan Teller reviews balanced scorecard gurus Robert Kaplan and David Norton's third book – and concludes that 'strategy maps' are a valuable technique for finance directors (FDs).

A picture is worth a thousand words. In the informative introduction to this book, the authors Robert Kaplan and David Norton describe how, as part of evolving their balanced scorecard concept, they had developed a diagram for laying out an organisation's strategy. They found that if they displayed the diagrams in a prominent location during the consultancy process, they attracted considerable attention from executives, thus ensuring their engagement. These diagrams became known as strategy maps.

As the title of the book states, the idea is to create value from intangible assets. They point out early on that intangible assets cannot exist in a vacuum. They need to be part of a value-creating process and Kaplan and Norton argue that the balanced scorecard – with its emphasis on combining focuses on shareholders, customers, internal processes and learning and development – is the best way to guarantee tangible outcomes.

Operational

The original balanced scorecard concept was developed for the operational level of an organisation. However as it began to be applied in practice, it was noticed that increasingly, it was used as a strategic tool. It was able to verbalise the strategy, communicating it to the organisation and enabling better measurement of strategy execution. Its emphasis on performance measurement ensured that individuals throughout the organisation knew how they should contribute towards the overall strategic goals.

Strategy maps are a natural and very powerful extension. They clearly lay out the route for putting the strategic plan into action. Importantly, they highlight dead ends.

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By way of explanation, a key concept of the balanced scorecard has been the need to interlink performance indicators to gain a cause and effect synergy. A well-drawn strategy map helps to decipher these links and also shows up initiatives that are not linked through to the overall strategic objectives.

The book recommends organising maps into strategic themes helping to break down an overall plan into its individual and more manageable components. By doing this, both dead ends and, more importantly, unsupported/unconnected initiatives can be thrown up. Examples are provided, demonstrating that a map can combine local, national and global strategic objectives.

Overall, strategy maps are a powerful development as part of the evolution of the balanced scorecard concept. The tool should be used to build, communicate and monitor the organisation's scorecard.

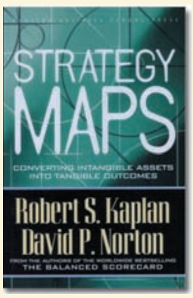
Gains

This is the third of four books written by Kaplan and Norton about the balanced scorecard. Strategy maps can be found in their second book but the idea certainly gains considerably by having a book fully devoted to the topic.

It is very detailed and rewards rereading. For example, early on they state that they use Porter's approach to strategy to provide generic themes and templates that can be adopted for faster implementation. However, you might not notice this the first time round if you are not looking for it.

A map can combine local, national and global strategic objectives

THE BOOK AND THE AUTHORS



Strategy maps: converting intangible assets into tangible outcomes
by Robert Kaplan
and David Norton

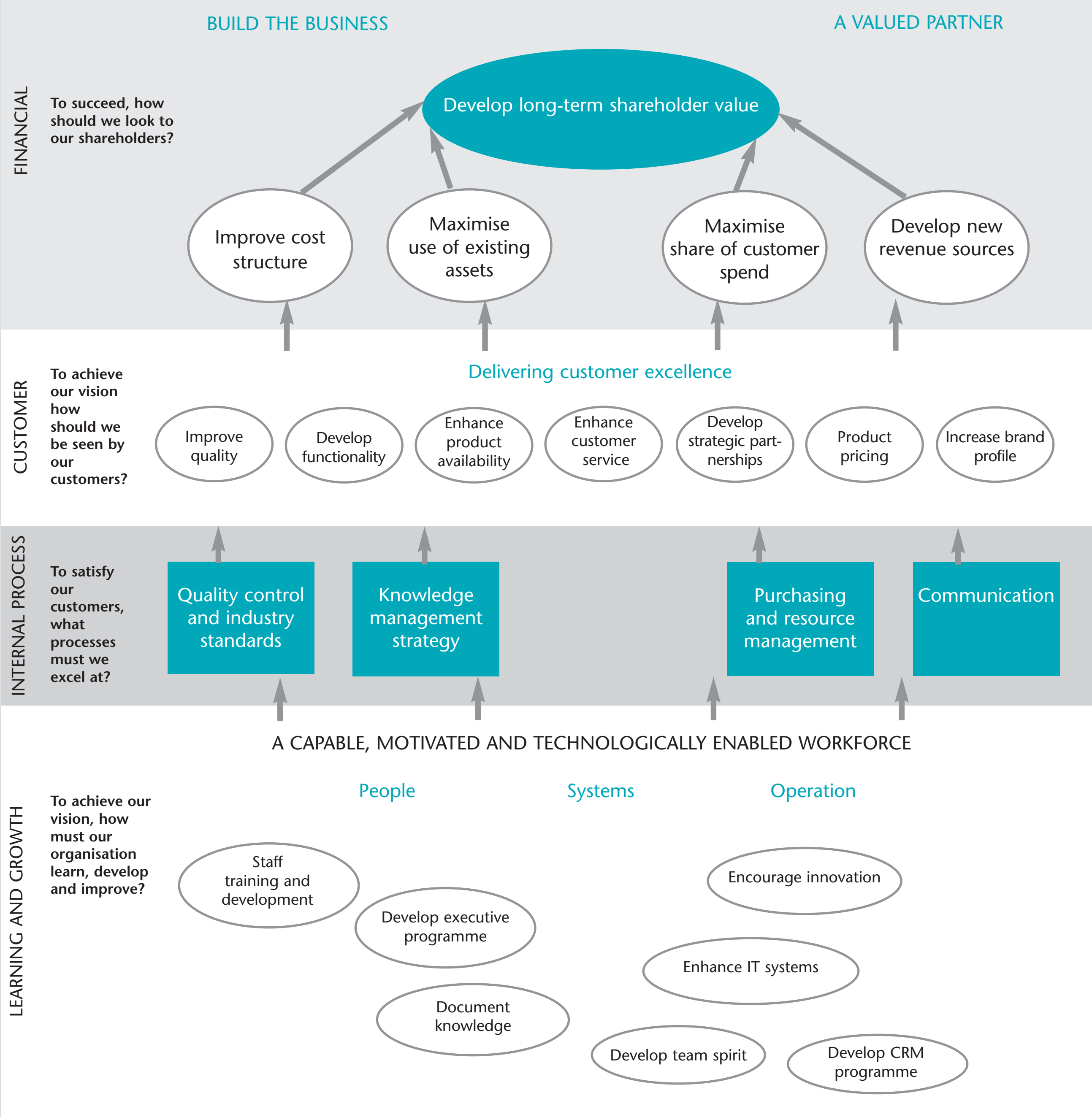
Harvard Business School Press (2004)

ISBN: 978-1591391340

Dr Robert Kaplan is the Marvin Bower professor of leadership development at Harvard Business School and is a co-founder and chairman of the Balanced Scorecard Collaborative (BSCol).

Dr David Norton is a co-founder, president, and CEO of BSCol. Together with his co-author, Robert Kaplan, he has written four books about the balanced scorecard, and articles in the *Harvard Business Review*.

FIGURE 1: EXAMPLE OF A STRATEGY MAP



For more information on strategy maps and performance management systems, visit www.performanceanalytics.co.uk

Numerous case studies are used to illustrate the concepts. Examples are given for non profit as well as commercial organisations. The level of detail makes this a very useful book for anyone creating maps for their organisation. **F&M**

FACULTY WEB LINKS

- 'Evaluating performance in IT' SR8 – www.icaew.com/index.cfm?route=126453
- 'Managing value with the balanced business scorecard' F&M83 – www.icaew.com/index.cfm?route=120455
- 'The balanced scorecard' GPG25 – www.icaew.com/index.cfm?route=121399

ONE YOU MAY HAVE MISSED

from the Faculty archive

At right, we provide a brief summary of a special *Finance & Management* report which readers have told us they found particularly helpful.

This report – and a wide range of other valuable material – is available on the FMF website.
To read this in full, see www.icaew.com/fmbest

PERFORMANCE MEASUREMENT

Measuring the performance of investment in corporate activity is one of the most difficult challenges for the finance director, who is often charged with ensuring value for money from these activities. Hard performance measures such as return on investment, economic value added, sales, profits etc are available, but functional activities usually have no independent objective measures.

Measuring performance – the cover of SR9, September 2005

In this 44-page special report, expert authors such as Sir Andrew Likierman, Andy Neely and Tim Ambler, among others, address the challenges.

Performance measurement is at the heart of what accountants do and we are experts in measurement. But it is not easy.

The measures that this report deals with provide a challenge in finding scientific solutions which are objectively robust. There are no simple answers and this report does not pretend there are. The report is designed to help members ask the right questions in order to measure performance in their own organisations.

IN FUTURE ISSUES

Finance & Management

The background to managed service companies

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and much more...

NEXT MONTH

Executive summary

A guide to the themes and topics which have been featured in Faculty publications over the past three months, with a summary of each, plus web links to the full article on the Faculty's website

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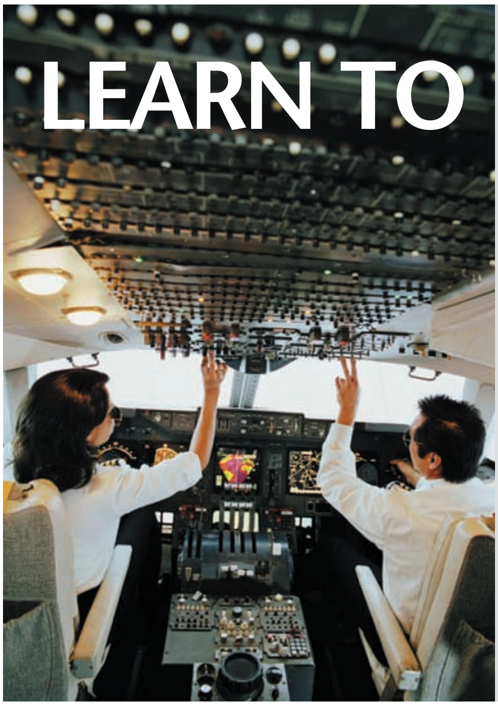

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