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The Kay Review
Department for Business, Innovation and Skills
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Dear Professor Kay

The Kay Review of UK Equity Markets and Long-Term Decision Making
Interim Report

ICAEW welcomes the opportunity to comment on the Interim Report of *The Kay Review of UK Equity Markets and Long-Term Decision Making* published by Professor John Kay on 29 February 2012, a copy of which is available from this link.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

ICAEW's submission to the call for evidence published by Professor John Kay in September 2011 may be viewed via this link (ICAEW REP 106/11). The Appendix to this letter sets out additional evidence on themes addressed in the Interim Report.

Please contact me in the first instance should you wish to discuss any of the comments raised in the attached response.

Yours sincerely

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APPENDIX

Chapter 4 Measurement and reporting

Quarterly reporting and interim management statements

1. The Interim Report (paragraph 4.4) states that 'There is wide consensus among respondents … that quarterly reporting and the preparation of interim management statements have adverse effects on the behaviour of companies and investors.' We agree with this consensus, and we hope that Professor Kay's Final Report will both support the removal of the existing EU requirement for interim management statements and help to reinforce the consensus in the UK that the introduction of a quarterly reporting requirement would be unhelpful.

Accounting for defined benefit pension schemes

2. The Interim Report makes a number of comments (paragraphs 4.8 – 4.13) about the use of 'mark to market accounting' for defined benefit (DB) pension schemes in the accounts of sponsoring companies. There are various aspects of sponsoring companies' accounting for DB schemes that may be regarded as 'mark to market'. First, the scheme's investments are measured at fair value (in substance, current market value). Second, its liabilities, to the extent that these are properly regarded as obligations at the balance sheet date, are measured at the discounted present value of the expected future payments. Third, the scheme's net surplus or deficit is reflected in the accounts of the sponsoring company, including to some extent in its income statement.

3. The report identifies two consequences of this approach, suggested by respondents to the review: 'an acceleration of the closure of defined benefit pension schemes and a substantial reduction in the commitment of UK pension funds to both UK and overseas equities'. On the question of accounting's contribution to the closure of DB schemes, we would draw the review's attention to a research paper commissioned by ICAEW, 'Have changes in pension accounting changed pension provision? A review of the evidence' by Paraskevi Vicky Kiosse and Ken Peasnell (*Accounting and Business Research*, 2009: copy attached). While this confirms that accounting has probably been a factor in the closure of DB schemes, it also points out that 'many other factors … have played a part in this change'. In particular, 'the desire to limit cash contributions has been the major determinant'. On asset allocation, the Kiosse and Peasnell paper confirms the view expressed by respondents to the review. However, it may be worthwhile to compare the asset allocation policies of DB schemes with those of, eg, DC schemes to see whether they too have reduced their dependence on equities. It is also possible that the move away from equities is as much a reflection of emerging concern about the mismatch of risks between funds' liabilities and their investments as of concern about accounting volatility, and we believe that this would be worth investigating.

4. Respondents to the review commented that these changes, in DB provision and asset allocation, have 'benefitted no one' – and the clear implication is that they are in fact changes for the worse. It would be worthwhile for the review to assess these propositions critically. Kiosse and Peasnell's closing comment is that 'It is hard to argue that DB schemes should be kept in existence if this can only be done by keeping investors and creditors in the dark about the risks involved.' We concur with this view, and we believe that the increasing use of current values for DB pension schemes in sponsoring companies' accounts has greatly increased the transparency of the risks and costs of these schemes.

5. As for asset allocation, we do not claim to know what the right level of equity investment for DB pension schemes at any given time should be, and we believe that it would be an interesting question for the review to investigate how this can determined. Until this question is answered, it is difficult to see how it can be decided whether any effects of accounting on asset allocation are beneficial or deleterious.

6. The report also refers to respondents' view that market values for something that is not intended to be immediately realised – 'such as the net liability to the pension fund' – are 'useless or misleading'. If users interpret the measurement as showing an amount that is about to be realised, then they would indeed be misled. However, we do not think that users are so ill-informed that they do see pension scheme assets in this way. Nor do we believe that measuring these assets at their historical cost would provide more useful or less misleading information. Also, although it would no doubt be most useful to show the future value of these assets, the obvious difficulty is that no one knows what this will be, and attempts to estimate it can easily become wishful thinking. So, while current market values are no doubt imperfect, we do not know of a better way of measuring the scheme's assets for reporting purposes. We note that the Interim Report does not suggest one.

7. Pension scheme liabilities are not measured directly at current market value, but at a discounted present value, using a current market discount rate. The consensus view is that a market value for the liabilities would typically be significantly higher than the amounts currently shown in accounts.

8. We should point out that the deficits for whose elimination the Pensions Act 2004 requires sponsoring companies to prepare plans are funding-basis deficits, not accounting deficits. The two types of deficit are measured in different ways, and accounting requirements do not determine the relevant amounts for the purposes of the Act.

Use of economic models

9. The Interim Report (paragraph 4.18) claims that 'Inappropriate reliance on [economic] models by both regulators and regulated firms themselves was an important contributor to the financial crisis of 2007-8.' We do not dispute this – as the report states, '[m]any of the models appear to have intrinsic short-term biases'. However, we hope that the report is not implying that the use of fair value accounting in financial reporting was an important contributor to the crisis.

10. The empirical research on this subject to date suggests that fair value accounting did not play a significant role in the crisis. On this question see, for example:
    - Mary E. Barth and Wayne R. Landsman, 'How did financial reporting contribute to the financial crisis?', *European Accounting Review* (2010);
    - Christian Laux and Christian Leuz, 'Did fair-value accounting contribute to the financial crisis?', *Journal of Economic Perspectives* (2010); and
    - Sanders Shaffer, *Fair Value Accounting: Villain or Innocent Victim*, Federal Reserve Bank of Boston (2010).

Chapter 5 Market practice

State of the IPO market in the UK

11. The Interim Report mentions the decline since the financial crisis of 2007-8 in new listings on the UK's Main Market and on AIM and sets out how respondents attributed this. We refer to the comment that 'when private companies sought an exit for their private equity investors listing was frequently seen as a last resort, to be undertaken only when other avenues – such as trade sale, reconstruction or sale of secondary interest – had been ruled out' (paragraph 5.3). We believe that this is simplistic and refer the review to the analysis of different types of exit for private equity contained in ICAEW's publication *Private Equity Demystified - An explanatory guide, 2nd edition*, by John Gilligan and Professor Mike Wright (chapter 2, 2.8). A copy is available from this link.

12. In our submission to the call for evidence (ICAEW REP 106/11) we referred to apparent disincentives for individuals to hold shares. This is also the view of small and midcap companies who responded to the BDO/QCA Small & Mid-Cap Sentiment Index, October 2011, and who desired the UK government to introduce tax incentives for investors in small and mid-cap quoted companies.

13. The majority of respondents to the same index conducted in February 2012 were supportive of a policy of allowing costs of raising equity to be tax deductible to a limit; this strengthens our suggestion, in ICAEW REP 106/11, that the extent of trade-off between listing benefits and the cost of IPO process in the case of smaller quoted companies should be explored.

Allowance for corporate equity

14. The Interim Report refers to the effects of the differential tax treatment of equity and corporate debt and to one of the canvassed ways of lessening the tax bias in favour of debt: an allowance for corporate equity (paragraph 5.7). We draw the review's attention to the analysis of this and other ways of reducing the distorting impact of the current tax treatment on companies' financing decisions in the IFS Mirrlees Review report, Tax by Design, the relevant extract of which is available from this link www.ifs.org.uk/mirrleesreview/design/ch17.pdf.

Chapter 6 Asset managers

Private equity

15. The Interim Report (paragraph 6.26) refers to respondents' view that private equity has a short term focus. This view suggests that private equity restricts investment in the businesses it backs, makes early exits and replaces equity with debt. We draw the review's attention to relevant academic findings.

16. Studies show that the average time to exit from private equity deals is five years plus and has been increasing over the past two decades. A summary of relevant studies may be viewed in Appendix Table 5 of *Private equity demystified, 2nd edition* (see above). On the review's theme of short versus long term, in the forthcoming 2012 edition, the authors argue that the important point is not the length of the period that private equity hold their investment, but how efficiently the people and assets of the investee business are deployed.

17. In relation to investment, studies show that private equity buy-outs result in increased patent citations and more focused patent portfolios. The studies below, for example, show an increase in innovation

    - Ughetto, 'Assessing the contribution to innovation of private equity investors: a study on European buyouts', *Research Policy* (2010); and
    - Lerner, J., Strömberg, P. and Sørensen, M. (2008), 'Private equity and long-run investment: the case of innovation', in Lerner, J. and Gurung, A. (eds), *The Global Impact of Private Equity Report 2008, Globalization of Alternative Investments, Working Papers Volume 1, World Economic Forum, pp27-42*.

    It is also worth making the point that private equity deals are heterogeneous – some create value by way of restructuring and efficiency improvements and others do so through growth.

18. In relation to the view that equity is replaced with debt, the study by U. Axelson, T. Jenkinson, P. Strömberg, and M. S. Weisbach. Borrow cheap, buy high? The determinants of leverage and pricing in buyouts. *Ohio State University, Charles A. Dice Center for Research in Financial Economics, Working Paper Series 2010-9, 2010*, finds that the main factors that do affect the capital structure of buyouts are the price and availability of debt so that when credit is abundant and cheap, buyouts become more leveraged. Agency conflicts between the private equity fund and its investors are also cited as a determinant of the capital structure of leveraged buy-outs.