LITTLEJOHN

capital markets news

The newsletter for the AIM and PLUS markets

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Is the UK a good location for holding companies?

Find out the pros and cons

Encouraging accountability or excusing short-termism?

The revised UK Corporate Governance Code

Share options

What to do when the share price goes 'south'

Welcome to Capital Markets News

Post Emergency Budget, there's no denying the UK tax regime is simpler than it was. And more inviting for global businesses than before. By contrast, corporate governance is more formal – particularly for smaller companies. In this edition we look at both these issues.

As Head of Capital Markets, **Mark Ling** has led teams involved with numerous London Stock Exchange listings, management buy-ins, buy-outs, and related corporate finance activities. He has extensive experience in bringing international businesses to the capital markets.

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Our main feature looks at how the June Budget may influence larger corporates considering the UK for their holding company. Overall we expect more companies to favour the UK but economic bad news could be off-putting, regardless of tax. Changes in corporate governance rules are proving controversial – though we should be thankful that it's not as regimented or expensive here as in the States. High-quality corporate governance for smaller companies is, in any case, a material consideration for many investors – and often a reason for choosing London over other world markets. See our final article for more details.

It's clear the lights are back on after a quiet summer for the markets. But how much of the activity will come to fruition with closed deals, only time will tell. Sentiment may be swayed by near-term economic news, but we'll have to wait and see the effect of the spending review. Some think the economy will go into a double dip. Others believe that reducing government spending will actually make private enterprise much freer. Watch this space.

As always, we welcome your views on the newsletter.

In Brief

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Non-audit services consultation

You may recall that, arising from its review of the banking crisis, the Treasury Select Committee called for a prohibition on audit firms conducting non-audit work for the same company and recommended that the Financial Reporting Council consult on this proposal at the earliest opportunity.

Almost all respondents were against an outright ban but said there should be improved transparency and governance. As a result, the Auditing Practices Board (APB) issued another consultation paper in July, linked to draft new guidance for audit committees. The proposed changes include:

- identifying particular categories and values of non-audit services to be specifically approved by audit committees
- distinguishing between non-audit services with a very low threat to auditor objectivity and those where the threats need more careful consideration plus increased disclosure
- the audit committee should assess the cost and efficiency benefits of the entity's auditor providing non-audit services against the real or perceived threats to auditor independence
- improved disclosures of the audit committee policy, including reasons why the audit committee decides to purchase non-audit services from the auditor rather than another party
- additional guidance on factors to be taken into account by an audit committee when the external auditor is being considered to provide internal audit services.

The consultation paper, which is available on the FRC website, invites comments by 23 October 2010.

VAT – a timely reminder

We are aware of clients falling into a VAT trap, as follows: if you are a listed company, the recovery of VAT on placement and new share issue costs (such as legal and consultancy) is dependent on the overall VAT status of the company.

If you issue new shares to raise capital to purchase a trading company – and provide support services to that trading company – you can potentially recover all the VAT on the placement costs. But those services must have demonstrable substance, such as a formal service agreement and records of service delivery, to ensure HMRC cannot challenge the credibility of the relationship. Otherwise, you may be deemed as acting purely as a holding company. In that case the VAT incurred on placement costs cannot be recovered.

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Keeping everyone happy

Share options are a well developed tool for incentive compensation of AIM and PLUS company managers. But what to do when the share price goes 'south' and the options are 'underwater'? Mark Ling reports.

In the USA re-pricing has been a consistent feature of the corporate landscape. In Europe, however, there's been little debate on the issue, perhaps fuelled by the 'just say no approach' of many institutional shareholders. But there has been a realisation that management should be energised to perform, particularly where the share price has not recovered from the depths of the recession.

Taking the wrong approach can lead to some unintended accounting consequences. It can also mean unhappy shareholders and criticism of the remuneration committee. For example, if a new grant is not sufficiently linked to the cancellation of the underwater options, the full fair value of the new and original options may be recognised simultaneously in the statement of comprehensive income – hardly an ideal outcome for anybody.

Alternative scenario

Another scenario is that the replacement options are 'more valuable' and do not have any vesting conditions or hurdles. Again, the full charge to the statement of comprehensive income is immediate – even if the grant is on the last day of the accounting period. I have heard it said that the key is to motivate the manager first and foremost and it is the accounting standards that are 'wrong'. Such statements miss the point that all the stakeholders in the business need to be considered when options are being reissued with both the short-term and longer-term impacts assessed.

The reissuing of underwater options is, and will remain, a method of giving something of worth – not as a reward for poor or relatively poor individual corporate performance against a peer group, but to align management and shareholders' short and long-term goals to produce maintainable income and a real capital gain that is shared equally – according to the risks associated with each party's 'capital' invested.

All I can say is take professional advice – and you may just keep everyone happy.

For more information on this issue, please see our website www.littlejohnllp.com/news/looking-at-the-options.php

"The reissuing of underwater options is, and will remain, a method of giving something of worth."

The UK: a good location for holding companies?

The reality of Government in a recession has forced the Chancellor to re-think the priorities he put forward last February when still in opposition. But June's Emergency Budget may have provided an opportunity for global businesses thinking of setting up their holding company in the UK. Littlejohn's Dominic Roberts considers the benefits.

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In February this year the then Shadow Chancellor George Osborne temporarily decided to stop banker-bashing and announced eight benchmarks by which we would be able to measure his performance. Though slightly less pressing than his promise to "Ensure macroeconomic stability by protecting Britain's credit rating", one of particular interest to those of us who advise international businesses was "Make Britain open for business by improving our international ranking on tax competitiveness". In other words, tax cuts.

On reaching number 11, Chancellor Osborne has not only had to alter his plans to take into account his new Coalition partners, but has also had to contend with, as he put it, "the largest budget deficit of any economy in Europe with the single exception of Ireland". Talk has therefore focused on austerity measures and deficit reductions. Along with the odd bit of banker-bashing, naturally. So has all this put any planned improvement in our tax competitiveness on hold? And how did the Emergency Budget affect the position of multinational businesses considering whether to involve the UK in their group holding structure?

Lower Corporation Tax

First, the good news. It appears that George has remembered much of his promise and has even persuaded his new Coalition partners of its worth, at least partially.

He announced a reduction in the main rate of Corporation Tax* by 1% each year from April 2011 to April 2014 (that is, from 28% to 24% over the period). This is a good start and would place the UK as one of the countries with the lowest headline Corporation Tax rates in the G20.

> *"Much of the UK's competition for European or global headquarter or holding company locations comes from Ireland and Switzerland, both of which are able to offer significantly lower headline rates."*

Notwithstanding this positive news, the Chancellor and our Government would be wise to remember that much of the UK's competition for European or global headquarter or holding company locations comes from Ireland and Switzerland, both of which are able to offer significantly lower headline rates.

But it would be remiss of me not to balance this concern with the observation that the actual UK tax rate is already a lot lower than the headline rate for many globally operating businesses. What's more, the general Corporation Tax exemption on overseas subsidiaries' dividends announced in 2009 in combination with the Substantial Shareholding Exemption offers various routes for reducing the overall tax burden.

EIS and VCTs

There was also good news for companies looking to raise funds at the smaller end of the market. Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) rules were dramatically relaxed, in that companies will now be able to trade internationally provided they have a permanent establishment carrying out a qualifying trade in the UK.

That the EIS can now potentially be used for fundraises involving overseas businesses is particularly useful, given that the increase in Capital Gains Tax (CGT) will make the CGT-free nature of a qualifying EIS investment even more appealing for smaller investors.

However, one should note that previous restrictions on qualifying trades will still apply and companies regarded as 'enterprises in difficulty' won't be able to receive this funding. Great stuff, though we cannot give young Osborne credit for this; the change is merely to bring the regime into compliance with EU regulations on state aid.

**The smaller rate will reduce from 21% to 20% next April and UK and "ring fenced" profits from UK oil extraction will remain at 30%.*

Non-doms status

Good news, too, that there was no real change to non-domiciled individuals' taxation. This means the UK is still a good place for non-doms, particularly those who have not lived here for at least seven tax years.

The planned consultation on the foreign profits regime, under which foreign branches are taxed, also sounds potentially favourable. A possible move to a purely UK territorial basis for taxation could dramatically lower the UK tax cost for some businesses.

VAT a drawback

So, were all the announcements in the Emergency Budget positive ones for those considering the UK for their multinational headquarters? Not quite. As you will already know, VAT will be increasing to 20% from 17.5% on 4 January 2011. Though, in my personal view, the increase was a better option than any alternative increases in direct personal or corporate taxation, it will result in higher costs for any UK businesses unable to recover their VAT on services and goods purchased. This will exacerbate the tax disadvantage for certain VAT exempt UK resident companies, compared to those located offshore.

Fortunately the rise should only affect a minority of global holding companies based in the UK, as many are able to register for VAT through the provision of services to international subsidiaries.

Employer NI contributions

Bad news also came with the announcement of the 1% increase in employer National Insurance contributions (aptly named the 'jobs tax' pre-Election) and the continuation of the 50% upper income tax band (despite all the evidence showing it is at best tax-neutral, if not negative).

There was also delay in providing companies with clarity on the simplification of the Controlled Foreign Companies regime. The overhaul is now scheduled for 2012 following a consultation process that began in 2007, though in the Government's defence we will have to see what is announced as the 2011 interim measure before passing too severe a judgement.

All this shows that there is still much work to do to get politicians of all the major parties to understand what's being considered by many international businesses when deciding whether to choose the UK for their holding companies, regional headquarters or indeed principal base of operations.

Many attractions

All things considered, I believe the UK is a more appealing place to locate a global holding company than it was before 22 June, and dramatically more so than in 2001 when the young George Osborne became an MP.

The attractions are many. The reduction in Corporation Tax, the possibility of EIS or VCT relief for an increased number of businesses, planned improvements in the foreign company and profits regimes, a background of a mature and generally favourable tax treaty network, the lack of withholding taxes on dividends or capital gains, the exemption from taxation of most overseas subsidiaries' dividends, and the Substantial Shareholding Exemption on gains on subsidiaries. All these make the UK a surprisingly favourable jurisdiction for many multinational holding companies. The negatives I have mentioned will hopefully prove only minor annoyances for most of these, though not of course for UK-based businesses generally, and their costs should be more than offset by the recent improvements.

Though many other countries will still be suitable, depending on the individual circumstances of a business operating internationally, don't be too surprised if you start to find your tax advisor recommending the UK as a jurisdiction a touch more often than was once the case.

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Encouraging accountability or excusing short-termism?

The Financial Reporting Council's revised and renamed UK Corporate Governance Code has been causing ructions at some FTSE 350 companies since its publication in May. But it's still early days for assessing its overall impact. Harender Branch, partner at law firm Dawsons, explains.

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Company directors could have their remuneration reduced to take account of poor decision-making under new measures announced by the Financial Reporting Council (FRC). These are set out in their UK Corporate Governance Code, published on 28 May 2010.

Introducing the new Code, FRC chairman Baroness Hogg said,"The changes we have made are designed to reinforce board quality, and focus on risk and accountability to shareholders."

The Code applies to all companies with a premium listing of equity shares, and to accounting periods beginning on or after 29 June 2010. Companies listed on AIM, or whose shares are traded on PLUS, are not formally required to comply with the Code, although it is often adopted as good practice. The Code sets out standards of governance for listed companies – and they are required either to follow the Code or explain how else their conduct promotes good behaviour. This is often referred to as the 'comply or explain' approach.

The most significant changes have been made to encourage responsible attitudes to risk, to deal with the perceived need for greater board accountability and, in theory, to eradicate short-termism.

Promoting long-term success

A key omission in the 2008 Code was the failure to allocate responsibility for risk. The FRC has now made the board responsible for determining the nature and extent of risks that a company takes.

The Code recommends that companies enforce this by linking directors' remuneration packages to long-term success, stating: "performance conditions should be relevant, stretching and designed to promote the long-term success of the company." It encourages companies to link directors' pay to risk policies and systems, and align payouts with challenging performance criteria which reflect the company's objectives.

In a move to address the huge and controversial payouts recently given to departing directors of failing companies, it also suggests that companies should carefully monitor early termination compensation and ask directors to return compensation in exceptional circumstances of misstatement or misconduct.

Further changes

It's not just directors but also institutional investors who have been targeted. In fact 'Schedule C' of the Code, dealing with engagement principles for institutional shareholders, was replaced on 1 August by the UK Stewardship Code, which sets out good practice for investors when engaging with listed companies. From October 2010, the FRC plans to list on its website all investors who have reported on their compliance with this amendment.

Also ongoing is the Higgs' Guidance, which will complement the Code on the practical implementation of the principles relating to the leadership and effectiveness of the board. This is in its second consultation period and comments on the draft guidance are requested by 14 October 2010.

Annual re-election of directors

Perhaps the most contentious change is the introduction of annual elections for directors of FTSE 350 companies. Though it is welcomed by shareholders who would like to have a greater say in how companies they invest in are run, it is opposed by some companies – including British Airways, Tesco and Sainsbury's – who believe it exposes them to manipulation by shareholders and has the potential to stifle board decision-making.

A major concern is that annual re-elections will encourage directors to make decisions that are popular with investors rather than in the best interests of the company. Recommending dividends, for example, may take precedence over pursuing unpopular strategic goals. Both the Confederation of British Industry and the Institute of Directors believe this move could lead to short-termism: all highly ironic given the FRC's desire to promote the very opposite.

A way forward

Regardless of the mixed response, it is clear that the new measures are designed to encourage accountability and diversity and to improve performance. Companies should take this opportunity to carry out an audit of board policies and directors' remuneration packages so that these comply with best practice. If they don't, the board will need to justify its decision to proceed on a different basis. But one would hope that increased director accountability will lead to greater transparency in relationships between boards and shareholders, which must surely be encouraged.

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Littlejohn is an independent, top 30 firm of chartered accountants and business advisors. A leader in providing audit, taxation and transaction support services to clients either already listed on the AIM or PLUS markets or planning to list, Littlejohn helps clients to overcome the challenges they face through a comprehensive commercial and technical understanding of their business and a high level of partner involvement. Clients range from small listed cash shells to multinational corporations operating in a number of countries.

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