Chantrey Vellacott DFK

Pensions Group

Employer Covenant Review

Following the Pensions Act 2004 and the establishment of the Pensions Regulator, Trustees are now required to perform regular reviews of the financial strength of the sponsoring employer to ensure it can meet its obligations to the scheme. This is referred to as an Employer Covenant Review.

In consultation with actuaries and pensions lawyers, Chantrey Vellacott DFK has developed a range of services to assist Trustees meet their statutory obligations and fulfil their fiduciary duties.

Actuaries are also expected to take account of the strength of employers' covenants when advising Trustees, and will often find an independent covenant review to be of assistance.

Benefits to Trustees

An Employer Covenant Review provides Trustees with an independent assessment of the financial position of the employer and of the risk that the employer may be unable to meet its obligations to the scheme.

This information will benefit Trustees in the following ways:

- It will enable Trustees to take account of the employer's financial strength when negotiating with the employer on both the level of the scheme's funding target and the associated contributions schedule.
- Where the scheme has a funding deficit, the schedule of contributions should incorporate a recovery plan, negotiated between the Trustees and the employer, to bring the scheme up to the target level of funding. A covenant review will assist Trustees in determining what the employer can afford to pay and in what timescale.
- It will assist Trustees consider what additional steps can be taken to safeguard the position of the scheme.
- It will assist Trustees in considering whether steps can be taken to reduce the level of the risk-based Pension Protection Fund ('PPF') levy.
- It will enable Trustees to estimate the likely effect on the scheme should the employer enter into a formal insolvency procedure.

Our Services

We are able to provide Trustees with the following services:

- Desktop Review
- Full Review
- Ongoing Monitoring
- Ad Hoc Reviews
- Negotiation of Recovery Plan

We believe that wherever possible, Trustees and employers should work together to find a mutually acceptable solution to issues. We in turn aim to work alongside scheme actuaries and solicitors.

We have particular expertise in performing covenant reviews of:

- Private companies
- Listed companies outside the FTSE 350
- Charities
- Partnerships and LLPs
- Membership Organisations

We never forget that our fees are paid by the scheme and we will ensure that:

- Our fees are agreed at the outset and are proportionate to the size of the scheme and the structure of the employer.
- We give value-added information and advice on steps the Trustees can take to protect the position of the scheme.

Desktop Review

Our Desktop Review provides an assessment of the strength of the employer's covenant. Because the review uses publicly available documents, plus information provided by the Trustees, this is an extremely cost-effective service for Trustees.

Typically, a Desktop Review would include:

- An analysis of the employer's balance sheet
- A comparison of the pension obligation with the assets of the employer
- A review of the employer's debt structure and comment on whether the employer is generating sufficient cashflows to meet its obligations
- An analysis of any group structure
- A review of key financial ratios
- A review of the employer's credit rating

We can also advise on steps Trustees might take to protect the scheme such as:

- Obtaining security (whether actual or contingent) from the employer or from a third party
- Requesting cash to be held in escrow
- Obtaining covenants, negative pledges or group guarantees from the employer
- Considering whether credit insurance for future contributions is appropriate

Full Review

Where the Desktop Review has highlighted potential problems, Trustees will often wish to commission a full review of the employer's affairs.

This will usually require the co-operation of the employer, including access to management accounts and trading / cashflow forecasts.

Our review will also examine the implications for the scheme should the employer enter into a formal insolvency procedure.

Ongoing Monitoring

Trustees should keep abreast of matters which affect the strength of the employer's covenant, and should try to protect the position of the scheme in the event that the employer enters a period of distress.

This is best done by holding regular meetings with the employer, and regularly reviewing the employer's management accounts. Trustees should be alert to matters which could adversely affect the strength of the employer such as:

- Trading losses
- Diminution of market or market share
- The granting of security to a lender
- The loss of a major customer
- Major litigation against the employer

We are happy to provide ongoing advice and reports to Trustees or to covenant sub-committees, and to attend meetings with the employer.

Ad Hoc Reviews

One of the most difficult tasks facing Trustees is reviewing proposed transactions involving the employer to ascertain how they will affect the strength of the employer's covenant.

Trustees will often have powers to demand additional contributions in the event that a proposed transaction will impair the covenant.

The Regulator has made it clear that he expects Trustees to take advice as to what can be done to ensure that the financial security of the pension fund is not jeopardised.

We are able to review a proposed transaction and advise Trustees as to whether it is likely to materially weaken the employer's covenant.

Examples of such transactions include:

- Mergers / acquisitions
- Leveraged transactions
- Payment of unusually high dividends
- Group restructurings
- Changes of ownership

Negotiation of Recovery Plan

Where an actuarial valuation reveals a funding deficit (i.e. a shortfall in assets compared to the funding target), the Trustees and employer are required to agree a recovery plan to bring the scheme up to the target level of funding. The recovery plan will be incorporated into the schedule of contributions.

The timescale for any recovery plan is a matter for negotiation but the view of the Regulator is that Trustees should aim to eliminate the deficit as soon as the employer can reasonably afford, taking into account the employer's financial position and its ongoing business plans. The Regulator has stated that deficits should ideally be eliminated within a 10-year period.

Where the sponsoring employer is financially strong and is likely to have no difficulty in repaying the deficit over time, the negotiations may be relatively straightforward. Indeed the combination of the PPF's risk based levy, and the fact that pensions liabilities now appear on company balance sheets, may well make employers more receptive to reducing deficits quickly.

The difficulty for Trustees arises when the scheme is in deficit and the employer's financial position is weak. Trustees must balance the need to reduce the deficit quickly with the fact that if they push too hard, the employer may be forced into insolvency.

We can assist Trustees in determining how much the employer is likely to be able to afford and can advise on the appropriate timescale for the plan.

Who To Contact

Kevin Murphy FCA
Business Recovery Partner - London

Kevin is a licensed insolvency practitioner and is a partner in our Business Recovery Division. He has expertise in reviewing the financial strength of companies on behalf of lenders, directors and pension scheme trustees.

Kevin is a member of the editorial board of 'Recovery', the quarterly journal of the Association of Business Recovery Professionals (R3).

Tel. 020 7509 9300
Email. kmurphy@cvdfk.com

Michael Cannon FCA
Pensions Partner - London

Michael, a partner for 25 years, is based in our London Office and heads our Pensions Industry Group.

He acts as partner for a significant number of schemes, ranging from those with over 1900 members and assets of £125million to closed and small self administered schemes. In this role he is familiar with not only auditing and reporting matters but also addressing issues facing Trustees and attendance at Trustees Meetings and liaison with actuaries and other advisors. He is also the audit partner of some of our largest commercial clients.

He is a member of the ICAEW Audit Registration Committee and has recently been appointed to the Professional Standards Board. Michael is a member of the City branch of the NAPF.

Tel. 020 7509 9240
Email. mcannon@cvdfk.com

Stephen Corrall FCCA
Pensions Partner - Croydon

Stephen, who is a senior member of our pensions group, is head of audit in our Croydon office and is responsible for the management of the pensions unit in that office. Stephen has specialised in this work for approximately ten years. Stephen is a member of the Pensions Research Accountants Group (PRAG) and of the Southern branch of the National Association of Pension Funds (NAPF).

Stephen has been actively involved in tailoring the firm's audit approach to pension schemes and regularly contributes to internal seminars.

He has advised a number of schemes on the strength of the employers covenant and the options available to the Trustees.

Tel. 020 8633 9374
Email. scorrall@cvdfk.com

David James BSc(Econ) FCA
Pensions Partner - Watford

David, a partner in our Watford office, acts for a number of pensions clients, including a multi-employer scheme with over 6,500 members and assets of over £650million and several occupational schemes.

He also has direct experience in undertaking employer covenant reviews.

David also has a keen interest in educational matters and serves as a governor at a local Further Education College

David fulfils the role of the office's technical audit partner and also serves clients in a variety of sectors.

Tel. 01923 255111
Email. djames@cvdfk.com

www.cvdfk.com

Case Studies

Ad hoc review
Prior to the recent merger of two well-known media companies, we were asked by the Trustees of the pension scheme of one of the companies to advise on the effect of the merger. We advised the Trustees that the merger would not have a detrimental effect on the employer's covenant.

Desktop review
We recently advised the Trustees of a pension scheme which had a huge deficit in relation to the assets and profitability of the employer, and reported on the available options together with an analysis of the outcome in the event of the insolvency of the employer.

Ongoing monitoring
We are currently providing ongoing monitoring on the strength of the sponsoring employers for the trustees of a multi-employer scheme. This includes a critical review of the employers' financial information and reporting to the trustees on matters to be addressed in their negotiations with the individual employers.

About Chantrey Vellacott DFK

Chantrey Vellacott DFK is a long established "Top 20" firm of chartered accountants that traces its roots back to 1788. The firm has 50 partners and some 250 staff. In addition to our principal location in London, we have offices in Brighton & Hove, Colchester, Croydon, Leicester, Northampton, Reading and Watford.

We work with quoted companies and privately owned businesses drawn from a wide range of commercial sectors. Our clients include professional partnerships, regulatory bodies, charities and other not-for-profit organisations, public sector bodies and private clients

We have a strong pensions practice and audit over 150 schemes ranging in size from £750 million of assets and over 11,000 members through to single member schemes. Members of our team are involved with the National Association of Pension Funds (NAPF) and Pensions Research Accounts Group (PRAG).

Chantrey Vellacott DFK has considerable expertise in reviewing the financial strength of companies and groups. We are often requested to perform such reviews by lenders who are worried that a loan may not be repaid or by purchasers of businesses as part of their due diligence. We frequently act as expert witnesses in matters relating to business valuations.

We are a leading member of DFK International, a worldwide network of independent accounting firms. Its international headquarters are located in our offices in London.

Chantrey Vellacott DFK Offices

London
Russell Square House
10/12 Russell Square
London
WC1B 5LF

Brighton & Hove
1st Floor
16-17 Boundary Road
Hove
BN3 4AN

Croydon
Corinthian House
17 Lansdowne Road
Croydon
CR0 2BX

Leicester
Artisan House
6 Princess Road West
Leicester
LE1 6TP

Northampton
Derngate Mews
Derngate
Northampton
NN1 1UE

Reading
Prospect House
58 Queens Road
Reading, Berkshire
RG1 4RP

Watford
Gresham House
53 Clarendon Road
Watford, Hertfordshire
WD1 1LR

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This newsletter has been written for the general interest of our clients and contacts. It is essential to take advice on specific issues. We believe that the facts are correct as at November 2005 but there may be certain errors or omissions for which we cannot be held responsible.

The opinions expressed in guest articles are those of the respective contributors and their firms. We believe that these should be of interest to our clients and contacts but the articles do not necessarily represent the views of Chantrey Vellacott DFK LLP.

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Chantrey Vellacott DFK LLP is not authorised under the Financial Services and Markets Act 2000 but we are able in certain circumstances to offer a limited range of investment services because we are members of the ICAEW. We can provide these investment services if they are an incidental part of the professional services we have been engaged to provide.

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