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By email: codereview@frc.org.uk

Dear Sirs,

Response to FRC UK Corporate Governance Code Consultation

Smith & Nephew plc (the **Company**/**S+N**) is a public limited company incorporated in England and Wales providing a portfolio of medical technologies to customers in more than 100 countries around the world. It is listed on both the London Stock Exchange (**LSE**) and the New York Stock Exchange (**NYSE**).

As a premium listed company, we are already subject to the requirements of a number of governance frameworks, including the Companies Act, the Financial Conduct Authority (**FCA**) Listing rules, the Corporate Governance Code in the United Kingdom, the SEC listing rules and the Sarbanes-Oxley Act 2002 (**SOX**) in the United States.

We thank you for the opportunity to comment on the consultation and to contribute to the improvement of the Code in order to ensure that the proposed reforms benefit the UK as an investment destination whilst maintaining its international reputation for high standards of corporate law and governance.

We welcome the intention to make the UK Corporate Governance Code a more robust framework which provides further improvements in the quality of reporting and transparency and support a number of the proposals in the consultation.

Please find enclosed our responses to the Financial Reporting Council (**FRC**) consultation on the proposed changes to the UK Corporate Governance Code. We have provided our responses to individual questions in the Appendix.

The key themes which we would like to draw from our responses are as follows:

- The UK's strong corporate governance reputation is crucial to its ability to continue to attract and retain capital. Increasing the compliance burden and cost for companies may affect the UK's competitiveness as a preferred destination for corporate and capital markets activity. It is essential that proportionality is applied to all matters concerning company regulation. In the event that significant and disproportionate new rules on companies and directors were introduced, this would be at odds with the Government's ambition to make London a more attractive listing venue.

- Directors will have significant additional obligations under the revised Code. With listed companies already struggling to attract talent, there is a real concern that the quality and diversity of boards will suffer (which is contrary to the intention of the FRC and government) with directors citing concerns of overregulation and incurring potentially unlimited personal liability. The impact on Board committees is also likely to be significant, with non-Executive directors being expected to do more than their traditional supervisory role and an increased exposure to the risk of regulatory sanctions.

- Many of the additional changes are supplementary in nature and may not lead to the intended benefit of improving the quality of reporting. We feel that many of the changes could be dealt with through FRC guidance referred to in paragraph 10 of the consultation. We would also like to see the FRC review existing guidance to be made it more concise and user friendly e.g., through hyperlinks to the relevant provisions of the Code.

- We would encourage a cohesive and simplified approach to the proposed reforms. Imposing additional obligations over subject matter which is already covered by other regulations leads to uncertainty and potential confusion among directors and companies. Reforms should ensure that there is no duplication with other regulations including without limitation the FCA's Listing Rules.

- We would also like the FRC to ensure that changes in the Code on ESG matters are consistent and comparable with the long awaiting guidance on ESG from the SEC and other countries. Since most of the companies within the FTSE 350 index have international operations, it is important that the UK Corporate Governance Code is aligned with other regulations in key markets. This will reduce the costs and complexity of reporting, which is becoming increasingly onerous for large companies.

- We would caution that overregulation would have the effect of significantly increasing cost and resource requirements for UK companies. The Annual Report would become increasingly complex resulting in a significant increase in costs and resource requirements. We observe that a number of the new proposals are likely to increase costs significantly for companies, directors and audit committee members, reporting more broadly as well as increased costs to resource to implement and manage an enhanced internal control framework. We would welcome any measures to remove duplication and ensure that reporting requirements are streamlined and reduce reporting cost and resource requirements for companies.

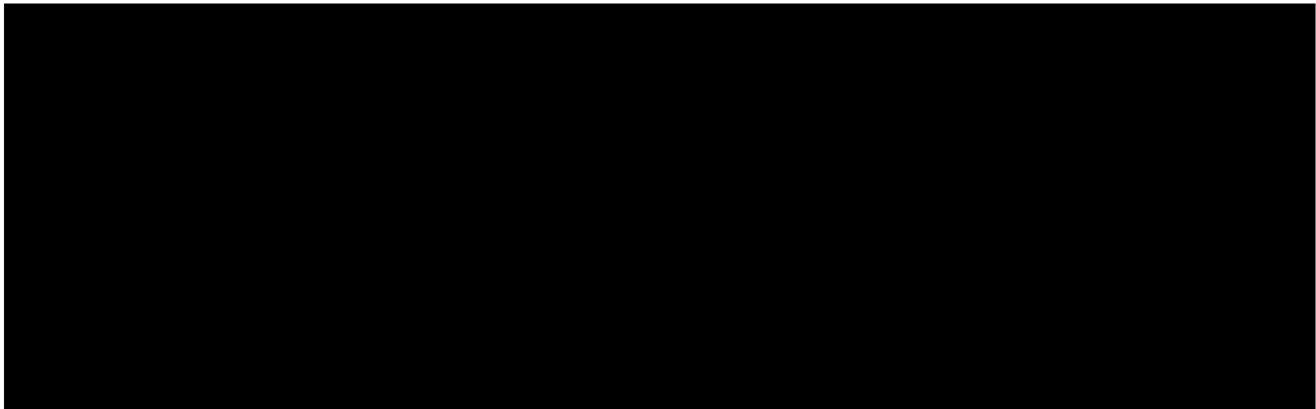
- The timeline set out i.e., accounting periods commencing on or after 1 January 2025 is likely to be challenging for a number of companies especially around the adoption of Section 4.

- We understand that a number of the proposals seek to provide additional opportunities for shareholders to engage in audit and assurance matters. We would like to note that shareholders and proxyholders currently do not engage significantly with companies and their decisions to engage are primarily driven by their own priorities as opposed to requests from companies to engage.

- We would also highlight that data collection for disclosures required by the proposed changes could be challenging, especially as some data is only provided on a voluntary basis (and therefore may not constitute a complete and accurate data set) and in many countries is also contingent upon legal and regulatory frameworks which may differ from those in the UK.

We hope that our comments provide constructive insight. Please do not hesitate to make contact should you wish to discuss any of our comments in further detail.

Yours faithfully,



Appendix:

<u>Section 1: Board leadership and company purpose</u>

Q1: Do you agree that the changes to Principle D in Section 1 of the Code will deliver more outcomes-based reporting?

As a listed company, we are already required to comply with Listing Rule 9.8.6(6), and we feel this adequately addresses the comply or explain requirements in relation to the provisions of the Code. We also feel that Principle D should be made consistent with Listing Rule 9.8.6(5) and should focus on how the principles of the Code have been applied.

Q2: Do you think the board should report on the company's climate ambitions and transition planning, in the context of its strategy, as well as the surrounding governance?

We do not consider that the changes to Provision 1 should be included in the revised Code. Section 172(1) of the Companies Act already requires directors to take into account environmental and social matters as part of their decision making and therefore Section 172 is the right vehicle for reporting in this area to avoid duplication. Section 172 guidance could instead include suggestions on how the statement could be drafted to address the FRC reporting concerns in this area.

Much of the disclosure required by the amended provision is already required under LR 9.8.6(8) and in due course will be required by the mandatory transition plan regime. This amendment would therefore be duplicative and should not be included in our view.

There have been multiple requirements around climate disclosure issued in recent years from a number of regulatory bodies. We would encourage the FRC to align with these requirements to reduce the burden on companies having to comply with multiple different requirements.

Q3: Do you have any comments on the other changes proposed to Section 1?

The proposal to change from "seek engagement" to "engage" between Committee chairs and shareholders on significant matters would be challenging in practice and "seek engagement" should not be replaced with "engage". Shareholders and proxyholders currently do not engage significantly with companies and their decisions to engage are primarily driven by their own priorities as opposed to requests from companies to engage.

<u>Section 2: Division of responsibilities</u>

Q4: Do you agree with the proposed change to Code Principle K (in Section 3 of the Code), which makes the issue of significant external commitments an explicit part of board performance reviews?

We are not aligned with the proposed changes to Principle K as explained below:

- Assessing the ability of a director to commit sufficient time to the role already forms part of the appointment process, the annual Board review and when an existing director requests approval from the Board or its Nomination & Governance Committee to take on an additional appointment. We feel this is sufficient and already deals with the concern in this respect.

- We would recommend that the Code should not be overly prescriptive on how Board evaluations should be undertaken. This could again be addressed in FRC guidance. The flexibility available to tailor evaluations to meet the needs of an evolving Board and boardroom dynamics is crucial in order to foster an ethos of continuous improvement.

- At S+N, we encourage our Executive Directors to serve as Non-Executive Directors of external companies. We believe that what they do as Non-Executive Directors of other companies has benefits for their executive roles with S+N, giving a fresh insight into the role of a Non-Executive Directors. We believe that by including the director's commitments to other organisations as part of their annual performance review they may be hesitant to take on other non-executive posts to gain relevant experience that could benefit the companies and their own personal developments.

- In addition, cross fertilisation of skills and experience may be lost if directors are forced to reduce the number of external roles they take. In an already small talent pool and coupled with the increased risk of regulatory censure, it would likely be more difficult to appoint directors with the required background and experience.

Q5: Do you agree with the proposed change to Code Provision 15, which is designed to encourage greater transparency on directors' commitments to other organisations?

Individual Directors and Boards will likely be reluctant to comment on how they manage their time and other commitments. This might also result in boilerplate reporting, which does not necessarily achieve the aims of the FRC in terms of improving the quality of reporting.

<u>Section 3: Composition, succession and evaluation</u>

Q6: Do you consider that the proposals outlined effectively strengthen and support existing regulations in this area, without introducing duplication?

We support initiatives that promote diversity and inclusion. However, the proposed reform would duplicate LR.9.8.6 (9) and data submissions and reports from FTSE Women Leaders Review. We therefore think the additional reform is not required. Additionally, we would welcome any measures to remove duplication and ensure that

reporting requirements are streamlined and reduce reporting cost and resource requirements for companies.

Q7: Do you support the changes to Principle I moving away from a list of diversity characteristics to the proposed approach which aims to capture wider characteristics of diversity?

We support initiatives which promote diversity beyond gender, social and ethnic backgrounds as Boards need to reflect the wider organisations and communities that they serve. However, we would suggest a simpler formulation on wording which still covers the aspects that the FRC and investors are focused on promoting equal opportunity and contributing to a diverse and inclusive board and senior management team.

Q8: Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior appointments?

We are not aligned with the proposed changes to Provision 14. Succession plans are highly sensitive and confidential, as they relate to individuals and their potential career progression. Any disclosure are very likely to result in high level and generic disclosures to avoid conclusions being drawn about individuals. This is likely to result in boilerplate reporting that does not provide value to stakeholders. Investors want to know that there is a planning process in place but in our experience are not interested in the level of details in the proposed revised provisions. The wording would also result in a duplication between the amended Provision 24 and the Listing Rule requirements.

Q9: Do you support the proposed adoption of the CGI recommendations as set out above, and are there particular areas you would like to see covered in guidance in addition to those set out by CGI?

We are supportive of the CGI recommendations but need to ensure that the guidance, which is intended to support companies, is not difficult to find and is linked clearly and streamlined appropriately to reduce the volume of guidance.

Section 4: Audit, Risk and internal control

Q10: Do you agree that all Code companies should prepare an Audit and Assurance Policy, on a 'comply or explain' basis?

We are pleased to see that the principle of "comply or explain" has been retained as it recognised that not all companies are the same and that in some cases, there could be very good reasons for a particular company to adopt a practice which might differ from the standard practice. However, many users of our Annual Reports and proxy advisors in particular (who tend to influence the bulk of overseas investors) do not give companies credit for "explaining" non-compliance with a provision even though the company might be adopting a more appropriate practice for the business. We are concerned that this approach by proxy advisors/investors is a threat to the continued viability of the "comply or explain" principle.

Q11: Do you agree that amending Provisions 25 and 26 and referring Code companies to the Minimum Standard for Audit Committees is an effective way of removing duplication?

We do agree that by referencing Provisions 25 and 26 to Minimum Standard for Audit Committee would reduce duplication.

However, there are some concerns around the changes in the Minimum Standard for Audit Committee which significantly expands the responsibility of audit committees which we highlight below:

"Engaging with shareholders on the scope of the external audit, where appropriate"

The scope of external audit would normally be based on the assessment of the auditors themselves and discussed for approval with the Audit Committee. The external auditors set out the scope of their audit work in order for the auditors to be comfortable to sign off their audit opinion. Year on year the scope of the audit would change based on the operation, development and associated changes in business risks during the year of the company. In practice, it is challenging to get any comments from the shareholders on the scope of the external audit as shareholders do not engage on audit and assurance matters with companies generally.

In our view, there is a risk that shareholders will want everything, including immaterial areas, to be audited or assured or lack the requisite knowledge of applicable assurance standards to adequately evaluate and opine on the audit scope resulting in non-standard scoping. This will have implications for non-audit fees and auditor capacity to perform this extra work. We are also concerned that if you do not get assurance then negative inferences will be drawn by investors.

Historically, there has been limited engagement by shareholders on audit related matters. In our experience, the Audit Committee discuss the audit plan in detail with our external auditors. The plan is risk-based and linked to the principal risks identified by the Board. To add in the additional step of seeking shareholder views on the audit plan would involve considerably more work by management, the audit committee and the auditors, which could cause severe delay on the already time pressure process. This additional work is only worthwhile if investors are also willing to put in the resource and actively engage with the company on the detail of the audit plan.

In the event that shareholders are invited to engage on the audit plan, consideration would need to be given as to the timing of this interaction. In any case this is going to require additional resource from both companies and investors. Even the most engaged shareholder cannot be expected to have the resources to understand the detail of every company in which they invest in the way that management, the Audit Committee and external auditors do. It is unclear from the Minimum Standard, whether it is intended that such engagement take place leading up to the annual general meeting or at some other time of the year.

If this engagement is intended as part of the annual general meeting process, it would not make sense to engage on an audit plan for a financial year that would now be concluded. The audit plan for the current year is a possibility, but the year will already have started, and initial work may already have been done. Whilst the audit plan for the next year would not yet be ready. In any event, there also needs to be provision to amend the audit plan to respond to events as they arise throughout the year, for example the impact of the current challenging economic environment.

However, if this engagement is intended to take place at some other time of the year, this would increase the costs and resources required for both companies and investors, involving two separate mailing/distribution processes and two separate engagement processes.

"The choice of auditor should be based on quality, including independence, challenge and technical competence, not price or perceived cultural fit; and

The Audit Committee should consider running a price-blind tender"

The tendering of audits to some extent is also similar to tendering for a vendor to provide a service to companies. We believe that whoever provides the best services (quality, technical challenge and competence) while meeting the regulatory requirements (independence) should be awarded. The technical evaluation may be undertaken prior to the commercial element of the tender being evaluated. However as long as the minimum technical criteria threshold has been met, vendor pricing is definitely an element we should consider for the service as it should be value for money.

Recently there has been constant increase in audit fees due to increases in regulatory requirements, without understanding the price structure of audit firms as a company it is difficult for us to budget and justify the effectiveness of the audit as well as the scope.

Like all vendors, it is important the auditors should have the same values as the companies they tender for so as to facilitate an effective audit. Furthermore, this is conflicting with the current requirement of assessing the audit's firm culture as one of the criteria for assessing audit effectiveness especially considering the recent audit failures.

Hence, we believe that pricing and culture should be an element of consideration as part of the tendering process.

"A typical tender process may involve three to four audit firms"

For a large, international company such as S+N, it is quite challenging for an audit firm outside the top four to be able to meet our requirements due to the lack of scale and expertise of these smaller audit firms. Therefore, we don't believe it is appropriate to specify the number of firms that should be involved in a tender process.

If some eligible audit firms are unwilling to tender for an audit, the Audit Committee should communicate with those firms to understand why they are unwilling to tender and whether there is anything that could be done to change

that. The Audit Committee should also consider asking those firms how such action is in the public interest. In such circumstances, the Audit Committee should ensure that it has not excluded other firms from tendering without good reason to believe they would not be able to perform a high-quality audit. The Audit Committee should remind eligible firms that refuse to tender that they may as a result be ineligible to bid for non-audit service work.

We note that in practice, even if the Audit Committee would reach out to firms that are unwilling to tender for an audit, it does not mean we would get an answer back. We do not think that using the threat of not being able to bid for non-audit service work is a practical way to persuade audit firms to tender and may result in audit firms incurring time and resources to tender when they have no real intention of taking on the audit.

Q12: Do you agree that the remit of audit committees should be expanded to include narrative reporting, including sustainability reporting, and where appropriate ESG metrics, where such matters are not reserved for the board?

It is important that companies are able to retain the flexibility to establish governance structures which fit their organisational structure. For example at S+N, in addition to Board engagement and oversight, we have established an ESG Operating Committee which provides information to our Compliance & Culture Committee, Audit Committee and Remuneration Committee on various ESG related matters.

It is also important for companies to understand the scoping of controls over these extended remits and the requirements for audit and assurance over those controls.

Q13: Do you agree that the proposed amendments to the Code strike the right balance in terms of strengthening risk management and internal controls systems in a proportionate way?

We do not agree with the proposed amendments as we consider that the existing framework of internal controls is generally fit for purpose. Increasing regulation of internal controls does not justify overburdening companies and management and diminishing the agility and quality of companies and their boards.

We would recommend that the FRC prioritises proportionality and balancing the costs against benefits of compliance on affected companies and limiting any stronger regulation to financial reporting controls only.

Q14: Should the board's declaration be based on continuous monitoring throughout the reporting period up to the date of the annual report, or should it be based on the date of the balance sheet?

Many directors will be unwilling to give such a statement without having a high level of assurance from management and potentially also external assurance from advisors. This proposal will inevitably result in increased costs and burden for companies.

We consider that the declaration should be given as at financial year end, neither throughout the reporting period or up to the date of the annual report. Many UK

companies with a US listing are already subject to Sarbanes-Oxley (SOX) requirements and we would ask to avoid creating a control framework that is significantly different to SOX requirements. If the new control framework is not aligned with SOX, we ask that at a minimum it will not be more burdensome than SOX.

There will need to be international alignment, particularly harmonisation with the US, otherwise there will be significant cost and reporting burdens where companies are required to report in multiple jurisdictions. International comparability is important in this aspect. The UK should make sure that our rules are comparable and consistent with international rules otherwise it will create additional costs and challenges for implementation.

Q15: Where controls are referenced in the Code, should 'financial' be changed to 'reporting' to capture controls on narrative as well as financial reporting, or should reporting be limited to controls over financial reporting?

We would prefer the scope to remain as currently drafted i.e., to be limited to controls over financial reporting for the following reasons:

- The narrative included in the Annual Report is already required to be checked for Fair, Balanced and Understandable as part of the current Code. Hence, additional controls over the narrative within the Annual Report would not add any additional benefit and could create duplication.

- For companies that are dual listed in the US and the UK, the proposal to include narrative is new and additional compared to SOX. Under the comply or explain approach, if a company departs from the Code, it stills need to explain why.

- We would also like to highlight the additional time and cost of implementing and maintaining a control framework over both narrative and financial reporting is significant and should not be underestimated. If change is necessary, it should focus on controls over financial reporting and not controls in general. The implementation of SOX was a huge effort back in 2002/2003 and the burden it will place on non-US listed companies, particularly as they are trying to deal with the current challenging economic and political environment, should not be overlooked.

- We would also highlight that this will not be a one-time exercise, but more likely an on-going requirement that will require business that are in scope to recruit and retain the resources and effort to maintain compliance and even to expend it as the regime continues to develop.

- Finally, we would also like to emphasise the fact that the expertise on SOX or control matters is currently heavily concentrated within the Big 4 audit firms and the requirements elsewhere in the consultation on the Audit Standard to include 3 to 4 audit firms in tenders would become even more challenging. Ultimately, this will result in significant additional costs for companies.

- To ensure the control framework work effectively, companies would need to understand the scope of the controls in the proposal, which is still unclear.

Q16: To what extent should the guidance set out examples of methodologies or frameworks for the review of the effectiveness of risk management and internal controls systems?

Principles and guidance will need to carefully balance prescriptive requirements and unambiguous definitions with flexibility. This will be necessary to avoid any duplication of effort by other regulators and confusion over their reporting responsibilities under existing legislation.

To ensure the control framework works effectively, companies would need to understand the scope of the controls in the proposal and how to assess for the effectiveness of these controls.

Q17: Do you have any proposals regarding the definitional issues, e.g. what constitutes an effective risk management and internal controls system or a material weakness?

The control framework of US SOX is only applicable for financial reporting and hence their definition and framework (COSO) could define what constitute as material for the financial statements.

In order to assess the effectiveness of risk management and internal controls system, companies need to understand the scope of the requirements and based on what these controls are assessed.

Q18: Are there any other areas in relation to risk management and internal controls which you would like to see covered in guidance?

It would be beneficial for companies if there would be a guidance on what to include in reporting controls, post balance sheet controls that the Board should consider if they are required to declare based on continuous monitoring throughout the reporting period up to the date of the annual report as well as guidance on when to apply resilience or viability statement for non-PIEs.

Q19: Do you agree that current Provision 30, which requires companies to state whether they are adopting a going concern basis of accounting, should be retained to keep this reporting together with reporting on prospects in the next Provision, and to achieve consistency across the Code for all companies (not just PIEs)?

We believe it is important for companies to state whether they are adopting a going concern basis, but it is important that it does not create duplication with the requirements of the reporting on future prospects.

Q20: Do you agree that all Code companies should continue to report on their future prospects?

We offer no comment on this question.

Q21: Do you agree that the proposed revisions to the Code provide sufficient flexibility for non-PIE Code companies to report on their future prospects?

We offer no comment on this question.

Section 5: Remuneration

Q22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?

Principle P is largely duplicative of Principal O and we do not feel it is required.

The proposed revisions could also result in making ESG conditions a mandatory part of remuneration arrangements restricting a company's ability to properly align incentives and strategy.

Under Provision Q there is a requirement to take workforce pay into account when determining remuneration outcomes. This is already dealt with in Provision 35 and duplicative so should be removed.

Q23: Do you agree that the proposed reporting changes around malus and clawback will result in an improvement in transparency?

We support the approach taken to malus and clawback which allows companies to tailor their malus and clawback policies to their particular needs and agree that the proposed reporting changes will improve transparency.

We would like clarity on whether the disclosure of the use of malus and clawback is required over a five year look back period or just over the last reporting period.

It is also noted that the SEC also recently introduced their own malus and clawback requirements. It would be important that the two requirements are aligned to avoid unnecessary burdens on companies.

Q24: Do you agree with the proposed changes to Provisions 40 and 41?

We agree that the deletion of Provision 40 and removal of Provision 41 requirement around subsequent reporting would reduce boilerplate reporting in the remuneration report.

Q25: Should the reference to pay gaps and pay ratios be removed, or strengthened?

We believe that the current reference to pay gaps and pay ratios are duplicative of existing statutory requirements and should be removed.

Other matters:

Q26: Are there any areas of the Code which you consider require amendment or additional guidance, in support of the Government's White Paper on artificial intelligence?

We feel that the existing provisions of the Code and developing regulations already provide the framework for considering the implications of new technologies which includes artificial intelligence (**AI**).

There is already industry specific regulation and guidance on the requirements of AI and software used in medical devices applicable for S+N, so it will be important to ensure that any further regulation or reform is not duplicative, is proportionate and does not place additional resource burden on companies.