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Dear Sirs

Response to FRC's consultation on the Wates Corporate Governance Principles for Large Private Companies

In our view, trust in business is an essential component in helping to shape a vibrant economy. Trust in business can be enhanced through companies adopting an appropriate corporate governance framework and reporting to shareholders, and other stakeholders, on how they have applied the key elements of that framework. In response to your request for comments on the proposed draft principles and guidance of the Wates Corporate Governance Principles for Larger Private Companies report, we set out below our observations in respect of the ten questions raised by you.

General Observation

The Wates Report is quite right to recognise that large private companies are not a homogeneous group, rather they encompass a wide variety of different ownership and legal structures. The challenge, of course, is providing one set of principles to which each of these companies must 'apply and explain' within the particular circumstances pertaining to their company. Even within the categories which you have referred to as examples, there are sub-categories for example those who are still under first generation ownership and those possibly under fourth generation. The latter probably having a much wider shareholder base with many shareholders quite removed, in terms of contact or influence, from the management team, thus impacting on the agency model you refer to.

We applaud the guidance for what it is, but also recognise that for those companies who choose not to embrace the principles but rather to treat it as a compliance exercise, the guidance will have little impact unless external oversight and challenge can be brought to bear. We note that the FRC presently has no statutory responsibility for monitoring the governance practices of premium listed companies and yet anecdotal evidence suggests many are supportive of giving a regulator more 'teeth' to address poor practice. So we have a concern that the existing proposals, whilst to be applauded in their aim, may only have limited impact and probably only on those companies who aspire to embrace good governance practices in the first place.

Our experience of monitoring the application of the UK Corporate Governance Code across all FTSE 350 companies for the last 17 years suggests that when new guidance, which requires a response which is not binary (yes or no), is issued, it typically takes up to 5 years for all those companies who wish to embrace it to do so, for example the adoption of good risk management disclosures which was 51% in 2013 has steadily increased to 80% in this year's review. However, a cautionary note as our research shows that it has taken 13 years for full compliance with the Code to grow from 29% to 72% as shown by this year's research.

We have also noted that more timely adoption is achieved where there is active engagement from interested, external parties, particularly shareholder representatives, regulatory or public interest. However, when that pressure eases or the focus of attention moves on, quite often the commitment to application of the principles eases with the resultant default being compliance and boilerplate.

In short, the principles that are proposed in the Wates Report are to be encouraged but without some form of external oversight, may have limited impact on those companies and those boards who do not embrace the underlying purpose of good governance.

With specific reference to the ten questions raised, our responses are as follows.

1) Do the principles address the key issues in the Corporate Governance Large Private Companies? If not, what is missing?

The currently proposed six principles cover all those aspects that are deemed good governance as reflected by the UK Corporate Governance Code for premium listed companies. However, they fail to recognise the primary responsibility (in Law) of the directors to the shareholders, a situation where in many cases (particularly where there are several generations involved) the responsibility of management is far greater because of the lack of individual influence available to an often diverse, uninformed shareholder base.

Principle 6 refers to stakeholders quite rightly reflecting the responsibilities of Section 172, but in so doing, omits to refer to the primacy of shareholder responsibility as referred to in Section 172. We therefore feel that in a private company arena, the interest of shareholders should be recognised under a separate principle which, in turn, may give focus and guidance as to how better communication and accountability can be achieved with shareholders.

2) Are there any areas in which the Principles need to be more specific?

The foreword to the principles refer to the importance of reporting on non-financial matters for the benefit of employees and stakeholders. While principle 3 refers to that information being used for the management of the business, no guidance is given to encourage companies to report on their impact on both the stakeholders and the communities in which they work.

The UK Code of Corporate Governance separately identifies audit risk and internal control. Given the size of these large companies there is a need for greater emphasis to be given to the importance of strong control, sound financial reporting and external audit. We feel that the importance of internal control oversight and external audit would be better emphasised by being contained in principle 4 along with risk management.

3) Do the Principles and guidance take sufficient account of the various ownership structures of private companies, and the role of the board, shareholders and senior management in these structures? If not, how would you revise them?

Accepted good practice is for a separation of the roles of Chair and CEO. Whilst not always practical in private companies we would suggest that specific reference is made to this in principle 2 in order to encourage best practice, always recognising that the option to explain is available.

We do not believe that presently sufficient emphasis is given to the responsibility of the board to shareholders. The guidance would benefit from further examples of the very nature of shareholder structures, including generational.

Furthermore, the issue of large subsidiaries of both UK and internationally owned groups need to be addressed so that where the ultimate UK shareholders are the same, the reporting requirements of the Code do not place greater burdens on those structured as subsidiaries rather than divisions.

The continuous strengthening and evolution of governance practices is essential to creating greater trust in society but, at the same time, the strength of the UK economy is based upon agile, innovative businesses operating on an even playing field. We therefore suggest that the responsibility for maintaining sound governance practices should be laid at the door of the largest corporate entities within the UK, with it having the responsibility for demonstrating how good governance is maintained throughout all of its operations be they in the form of statutory entities of operating divisions.

4) Do the Principles give key shareholders sufficient visibility of remuneration structures in order to assess how workforce pay and conditions have been taken account in setting directors' remuneration?

For many private companies, even the large categories, where the shareholders are also the directors, their 'reward' is often looked on as a combination of both remuneration and dividends. Further, their decisions are often influenced by the cash flow of the business and its investment needs, with the net amount to be "extracted" being a result of those decisions, i.e. they are not necessarily directly linked to contractual obligations. Accordingly, the use of KPI's to effect a simple comparison against others can be ineffective and potentially misleading. Accordingly, the principle that a board of directors should be mindful of ensuring that the workforce is properly paid, is to be encouraged. Further, guidance could be provided on this matter.

5) Should the draft Principles be more explicit in asking companies to detail how their stakeholder engagement has influenced decision-making at board level?

Principle 6 relating to stakeholders as currently drafted implies that a company should utilise such forms of (employee) engagement when taking decisions. As we have commented above, the success of the UK economy is dependent upon vibrant businesses being agile and responding to opportunities and external threats quickly and effectively. This principle is right to emphasis the need for a board of directors to consider how a company's activities may impact stakeholders, present and future, but decision making has to be agile as well and so we believe the current emphasis should be amended to reflect that the board should be mindful of stakeholder interests, particularly employees, when developing and implementing the strategy of the business but not imply that employees should be involved in the majority of decisions.

6) Do the Principles enable sufficient visibility of a board's approach to stakeholder engagement?

The majority of successful private companies will be mindful of the way they maintain engagement with, and awareness of, all their stakeholder's interests as without this sustainable success is rarely possible. The paragraph in Principle 6 as drafted draws the distinction between an accountability to material stakeholders on an annual basis and to others. We believe paragraph 4 sufficiently deals with this responsibility without having a specific requirement for separate reporting to material stakeholders. The need for a board to present a fair, balanced and understandable assessment of a company's position and prospects should, we believe, be included within a revised principle 4, as discussed above.

7) Do you agree with an 'apply and explain' approach to reporting against the Principles? If not, what is a more suitable method of reporting?

Our experience from reporting on corporate governance practices among the UK's largest companies (the FTSE 350) for 17 years, has shown how long it takes for companies to comply or explain. Peer pressure and the evolution of practice has brought about greater compliance and better explanations from the majority of companies such that, in this year's report (as yet unpublished), 72% of the FTSE 350 now state that they comply with the Code (2005:28%).

For private companies first seeking to adopt the Code, it needs to be recognised that they are at the early stages of this evolutionary process. Accordingly, the principle of apply (particularly relevant given the variety of different circumstances) and explain, should be encouraged and then supported with appropriate guidance rather than any failure immediately penalised. Further, it should be noted that there is a significant amount of effective guidance available to those companies and their directors who wish to enhance their governance practices. The benefit of apply and explain enables companies to pick and choose what is appropriate to their circumstances, for example the FRC's Guidance for Board Effectiveness issued in July 2018 and then adapt their practices as appropriate as the company evolves. The Wates Code simply needs to provide a reference to best practice guidance elsewhere rather than recreate it or elaborate on it.

8) The Principles and the guidance are designed to improve corporate governance practice in large private companies. What approach to the monitoring of the application of the Principles and guidance would encourage good practice?

The FRC presently have no legal mandate for enforcing the UK Corporate Governance Code. Equally, there is no regulatory authority to oversee AIM companies' governance practices. In the absence of a regulatory authority the most effective form of monitoring the application of principles has to rest with those stakeholders who have or might have in the future a vested interest in the sustainability of the company

The shareholders have the most influence in law and therefore, in the first instance, it is to the shareholders that one should turn to for holding companies to account for their governance practices. Other agencies, such as banks, employees and key suppliers can also influence the board, but only when they have significant influence through the provision of significant funding to the company, the existence an employee representative body, or through being a key supplier or customer of the company. Furthermore, it is inevitable that malpractice will, over time, be judged in Court against a set of recognised governance principles which, in turn, will drive greater adoption of the principles.

Change will take time and whilst likely that a formal monitoring process would accelerate the reporting against the principles, pragmatically the embedding of good practice will take time. Accordingly, we feel the need for formal monitoring should be revisited in a minimum of three years' time once the trend of adoption is clearer.

9) Do you think that the correct balance has been struck by the Principles between reporting on corporate governance arrangements for unlisted versus publicly listed companies?

Subject to the observations above, we feel that the current principles provide a sound basis on which to commence the journey.

10) We welcome any commentary on relevant issues not raised in the questions above.

We are concerned about the need to achieve a balance between encouraging sound governance practices – the acknowledgement of which is merely the start – and the need for organisations to act with agility in order to maintain a vibrant economy. While the nature of companies falling within this large, privately held category represents some 1500 companies, even within that range many are interrelated through various ownership structures. Consideration should be given to avoiding duplication and inefficiency.

Furthermore, we note that the Companies Act already requires particular disclosures relating to strategic reporting, non-financial reporting etc., which should form part of annual reporting and accountability and so do not necessarily need to be referred specifically to in the Code.

Yours faithfully,

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On behalf of Grant Thornton UK LLP

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