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Corporate Governance, Audit Reform and Shareholder Rights
Department of Business and Trade

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24 March 2023

Dear Sirs

Re: BVCA comments on Audit and Corporate Governance Reforms – New Reporting Regulations

We are writing on behalf of the British Private Equity and Venture Capital Association, which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK-based private equity and venture capital firms, as well as their professional advisers and investors. Between 2017 and 2021, BVCA members invested over £57bn into around 3,900 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital ("PE/VC") currently employ two million people in the UK, and 90% of the businesses our members invest in are small and medium-sized businesses.

Introductory comments

As we have set out in previous discussions and consultation submissions, an important part of the PE/VC business model is to build robust and effective governance structures, fostering growth and innovation and creating long-term value, as demonstrated by many academic studies. The PE/VC industry is committed to transparency, and examples of this in practice include the BVCA's work on the Wates Principles for Large Private Companies and the Walker Guidelines, implemented and monitored by the Private Equity Reporting Group ("PERG").

The BVCA continues to support, and be involved in, government initiatives on corporate governance reform. Through our work on the Wates Principles for corporate governance and the Walker Guidelines on transparency, large UK private equity-backed companies currently provide significant levels of disclosure. Indeed, in many of these areas, private equity-backed companies are leaders, with a sharp focus on effective governance and responsible stewardship. Companies covered by the Walker Guidelines already comply with some of the requirements currently applicable to Public Interest Entities ("PIEs"). Furthermore, the PERG has embarked on refreshing the Walker Guidelines to ensure that the industry continues to provide not only significant but also quality transparency and disclosure.

The private equity and venture capital approach

PE/VC firms are long-term investors, typically investing in companies for around three to seven years. This means a commitment to building lasting and sustainable value in the businesses they invest in. Typically, firms will sell their stake in a company by listing it on the public markets or, more frequently, selling to a strategic buyer. PE/VC firms raise capital to invest from sources such as pension funds, endowments, insurance companies, banks, family offices/high-net-worth individuals and sovereign wealth funds. PE/VC funds will invest in companies ("portfolio companies") in the earlier part of a fund's life until an agreed date (e.g. five to six years) and exit those investments in the run up to the fund's tenth anniversary (which can be extended). The fund's ownership percentage in the portfolio companies will vary depending on the PE/VC strategy (e.g. buyout, minority stake). Private equity acquisitions will often be partly financed by debt, often provided by a number of banks or other debt providers. Importantly, the portfolio companies will operate independently of each other and not as a single corporate group.

Overview of BVCA feedback

We welcome the opportunity to comment on the draft new reporting regulations and applaud that the proposals are being brought forward. The following sections in our response mirror the structure of the note titled "Covering note for stakeholders".

- General overview
- Resilience Statement
- Audit and Assurance Policy Statement
- Material fraud statement
- Distribution statements

General overview

1. *Scope of companies covered* – It is positive to note that the turnover and employee thresholds have been raised, resulting in a smaller number of less mature companies being disproportionately captured.

   However, we still believe there is a risk that basing the definition solely on turnover and/or number of employees could lead to disproportionate outcomes. Please see "Treatment of Groups" section below for an example.

   Additionally, whilst we recognise the need for defined thresholds, the definition of "large company" should be more consistent across all reporting requirements. For example, the following initiatives/definitions define a large company in different ways:

   - Wates Principles, which are relatively new and specifically address large private companies with different thresholds (more than 2,000 employees OR a turnover of more than £200 million and a balance sheet of more than £2 billion)
   - proposed reporting requirements considered here (more than 750 employees and an annual turnover greater than £750m)
   - PIE (more than 750 employees and an annual turnover greater than £750m).
   - TCFD (UK registered companies and LLPs that have more than 500 employees and a turnover of more than £500m)

It would be very helpful to have clarity on which principle would supersede the other if all thresholds are met and there is overlap within the reporting requirements of each.

2. *Staggered commencement dates* – The BVCA strongly supports the phasing in approach as set out in the note.

3. *Treatment of groups* – We generally agree with the treatment of groups under the new regulations. It is important to note, however, that it should be made clear in the regulations that separate portfolio companies are not considered part of the same corporate group merely by virtue of belonging to the same PE/VC fund's portfolio or different fund portfolios managed by the same manager.

   The structure of PE/VC funds, the way in which firms invest in and businesses, and the ongoing relationship between a portfolio company and the PE firm as a shareholder, are very different to those of a typical corporate group. Portfolio companies are acquired and sold by the fund more frequently than in a corporate group. The PE/VC fund buys the shares with a view to re-sale, holds them for investment purposes, and continues to rely on the underlying board of directors and management team to operate the business. PE/VC firms typically use a limited partnership to structure funds and an example of a typical structure is set out in the appendix.

   Other key features/information to consider:
   - PE funds exists to deploy investors' capital into a range of very different businesses to maximise investors' returns and spread their risk, and there is no element of unified management between portfolio companies, so:
     - Uncalled capital commitments are typically not drawn from investors to put into failing investments.
     - Funds cannot transfer money (dividends/proceeds) from a performing company to a failing one.
   - UK/International law in several areas reflects that portfolio companies of PE funds differ from corporate groups:
     - Their accounting treatment is different – funds are typically not required or entitled to prepare consolidated accounts including portfolio companies, unlike corporate groups. Accounting standards recognise these are financial investments and show them at fair value
     - Their tax treatment is different – funds receive no group tax advantages, such as group relief (for example the surrender of losses or sharing capital allowance excesses).
     - Portfolio company liabilities are entirely separate – liabilities are clearly ring-fenced between portfolio companies.
     - **Profits and losses are entirely separate** – generally cannot be offset or pooled with those of another portfolio company - proceeds are

contractually required to be distributed to investors, subject to very limited exceptions.

- This legal disaggregation reflects commercial reality and the very separate/different nature of portfolio companies – a fund could invest in businesses as different as online retailers and industrial manufacturers.

In addition, IFRS 10 makes it clear that investment firms, such as private equity firms, and their portfolio companies are not considered similar to corporate groups, as they do not need to consolidate portfolio companies into their accounts, as they would with true subsidiarises in a group.

It is critical that any new regulations reflect the specificities of a typical PE/VC fund and IFRS 10, and do not treat it in the same way as a conglomerate/large corporate group. It is not clear to us that this has been considered in either the Government response to the White Paper or the new reporting regulations.

Resilience Statement

As noted in our previous responses, in particular our response to the White Paper in 2021[1] ("WP response"), we believe that there are merits in the proposal for a Resilience Statement that consolidates the Going Concern and Viability Statements. The proposals have given some level of prescription on the nature of matters that should be captured, while at the same time allowing companies to decide upon the most relevant and material matters.

We agree that only one stress test should be required, which we proposed in our WP response and which is consistent with other UK financial services regulation. We would further recommend some detailed guidance around the application of the reverse stress tests and any scenario analysis. This will support companies to help ensure an appropriate and more consistent level of robustness as well as comparability between reporters.

We would question why this statement should sit in the Strategic Report and not the Directors report. Some clarity around this decision would be helpful.

We agree with the timeframe proposals and applaud the Government for taking on board our proposals in this area.

We also have the following drafting comments:

- 414CD(3)(a)(ii). We think this sub-section lacks clarity and could be read as requiring companies "to summarise the internal governance processes for managing.... the role of directors". Our view is that this refers to the role of directors in the risk governance processes? If so, we think it would be clearer to replace "and the role" with "including the role".

[1] 210708 BVCA response to BEIS consultation.pdf

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- 414CD(3)(c). Further explanation is needed as the requirement is unclear. Our understanding is that (a) would suffice, as the drafting of (c) seems to imply.

Audit and Assurance Policy Statement

It is our understanding that the regulations set out proposals for the Audit and Assurance Policy Statement, rather than the Audit and Assurance Policy. For the latter, we expressed support in our WP response for companies to have an Audit and Assurance Policy, as we believe it can help resolve confusion on how assurance is sought through various channels.

The regulations should clarify whether the Audit and Assurance Policy Statement is in addition to the Audit and Assurance Policy i.e. are they two separate documents. Would the Audit and Assurance Policy Statement sit within the annual report and refer to the Audit and Assurance Policy that is maintained and made available on the company website?

We also have the following drafting comments:

- 416A(1). Delete the comma between "must" and "contain". In the same section, there is a typo on the sub sections. It should be (a) to (f), not (h).
- 416A(3) & 416A(4). Clarification is needed on when a company falls in and out of scope. Although we understand there may be smoothing provisions, how will the requirement to update the Audit and Assurance Policy in every third year, and to provide brief annual updates, work for companies that have ceased to be companies with more than 750 employees and an annual turnover greater than £750m?

Material fraud statement

We recognise the increased focus on effective accountability of management and directors; we believe accountability must ultimately rest with the Board and management who need to determine the most appropriate way to prevent and detect material fraud.

The regulations should clarify that material fraud risks and incidents considered are both financial and non-financial. The regulations should also provide further clarification of material fraud risks to be considered.

We also have the following drafting comments:

- 416B(3)(a). There is a typo – "disclosure" is spelt incorrectly.
- 416C(1)(b). There is a typo – "medium" is spelt incorrectly.

Distribution statements

We are pleased the Government has moved the description away from the legality statement recognising that legality of dividends paid extends beyond distributable profits.

We support the concept of publishing a statement about distributable profits and distribution policy.

The regulations should clarify what is needed in terms of detailing the availability of distributable reserves. For example, whether this is a quantitative or qualitative disclosure. The

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policy should also recognise while distributable reserves are an important input in deciding the dividend-paying capacity, they are not the only factor.

We also have the following drafting comments:

- 413A, in point 4 on page 3, it states "In section 414C(11), after –", is this correct given that that the Audit and Assurance Policy will not be located in the strategic report?
- 416D(2). It is not clear that the confirmation required by s.416(2) can be given in respect of a future dividend, at least as regards compliance with s.851. Even if distributable reserves are shown in the accounts, an intervening event may occur which means that the directors would be in breach of their s.172 duty if they paid the dividend (for example, at the beginning of the Covid pandemic many boards cancelled, or withdrew recommendations to pay, dividends).
- In any event, in s.416D(2), delete the words "before the relevant annual general meeting" or amend the sentence to make clear that they apply to the date of the recommendation rather than of payment of the dividend. A recommended final dividend will be approved by shareholders at the AGM and paid after the AGM.
- 416D(2)(b)(ii). A company would not normally have to circulate interim accounts to members. Is this intended to create a new obligation to do so?
- Also, s.413A talks about accounts for financial years - is it clear that it also applies to interim accounts?

The BVCA would of course be willing to discuss this submission with you further - please contact Ciaran Harris (charris@bvca.co.uk) at the BVCA.

Yours faithfully,

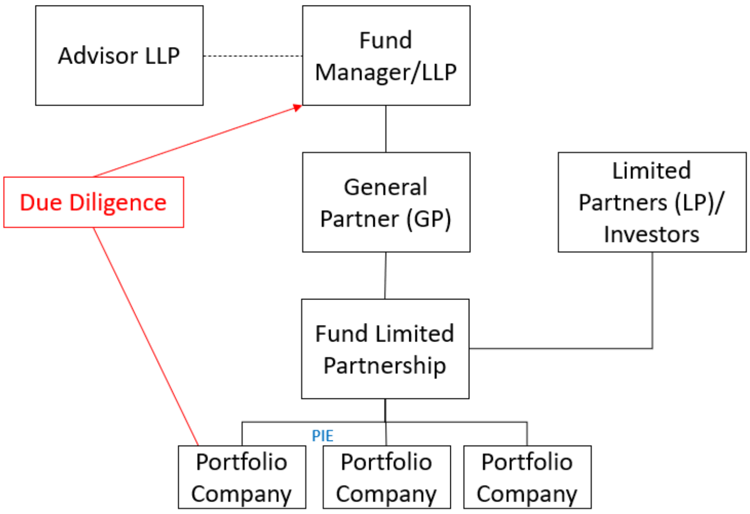
Tom Taylor

Head of Policy, BVCA

Appendix

Structure of a PE/VC fund and its portfolio companies

- The general partner of the limited partnership fund will delegate its power and authority to the private equity manager (often limited liability partnerships with the partners being the PE/VC executives).
- PE/VC firms will manage one or more funds. The funds have a limited life span, the industry standard being 10 years. The life span of a fund can be extended (if permitted in the fund's constitutional agreement) and this is typically up to two additional years.
- PE/VC firms raise capital to invest from sources such as pension funds, endowments, insurance companies, banks, family offices/high-net-worth individuals and sovereign wealth funds. These overwhelmingly institutional and well-informed investors will be limited partners in the fund and their liability is limited to the capital provided to the fund.
- The funds will typically invest in unlisted companies ("portfolio companies") in the earlier part of a fund's life until an agreed date (e.g. five to six years) and exit those investments in the run up to the fund's tenth anniversary. Typically, firms will sell their stake in a company by listing on the public markets or, more frequently, selling to a strategic buyer.
- The fund's ownership percentage in the portfolio companies will vary depending on the PE/VC strategy (e.g. buyout, minority stake).
- Private equity acquisitions will often be partly financed by debt, often provided by a number of banks.
- The portfolio companies will operate independently of each other.



Example for illustrative purposes only