# Corporate Governance in New Zealand

# Principles and Guidelines

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# Foreword

**The Minister of Commerce asked the Securities Commission in June 2003 to take a lead in developing corporate governance Principles for New Zealand. The Commission is pleased to present these Principles after an extensive process of public consultation.**

The public response showed significant support for a principles-based approach to corporate governance. We agree that this is a constructive way to maintain high standards of corporate governance, when combined with effective reporting on corporate governance practices.

This document sets out Principles developed by the Commission that will help New Zealand directors and boards of all types of entities to achieve consistently high standards in carrying out their corporate governance duties and responsibilities. The Principles support existing laws and regulations. The Principles do not impose any new legal obligations.

The Principles build on the Commission's consultation, as well as other work that has been done in New Zealand and overseas. New Zealand must heed policies and practices in other countries and aspire to standards of behaviour consistent with rising expectations in international capital markets.

The quality of corporate governance can play a key role in corporate performance. Improving governance should be a priority for all corporate entities. The Principles set out in this document are broadly stated to cover a wide range of companies and other entities that have economic impact or are accountable to investors or to the public more generally.

The Principles also recognise that different types of entities can take different approaches to achieving consistently high standards of corporate governance. Good governance practices should reflect the nature of each entity, and contribute to improved performance and accountability for that entity.

Transparency through high standards of reporting and disclosure is of paramount importance. Shareholders and other stakeholders can properly evaluate an entity and its governance only if they are fully informed. Accordingly the Principles focus strongly on reporting and disclosure of corporate governance structures and processes, as well as on reporting of financial and other material matters. Listed issuers are already subject to requirements under the Listing Rules to disclose the corporate governance practices they have adopted. These Principles should not increase the disclosure requirements for the many listed issuers whose governance practices and reporting are already of a high standard.

The Commission received a very good response to the consultation. We thank all those who took part for their constructive and thoughtful contributions.

Corporate governance practices in New Zealand are, by and large, of a good standard. The behaviour of boards and directors is the key to good corporate governance. We are confident the Principles will help directors and executives achieve the highest possible standards. We look forward to seeing the Principles implemented by New Zealand entities.

Good corporate governance should increase confidence in boards and management, and attract support from investors and other stakeholders. Ultimately it should make businesses more productive, competitive and financially sustainable.

**Jane Diplock AO**
**Chairman**

# Terms

| | |
|---|---|
| Board | the governing body of an entity, whatever called, including councils and local authorities. |
| Entity | any entity operating under a governing board that is accountable to investors and/or stakeholders. It includes companies registered under the Companies Act 1993, all issuers of securities, unit trusts and other collective investment schemes, and state-owned enterprises as well as many statutory bodies in the public sector. |
| Executive | employees of an entity who report to the board of the entity or to the Chief Executive Officer (CEO). |
| Executive director | a director who is an employee of the entity. |
| Independent director | a director who is not an employee of the entity and who does not represent a substantial shareholder and who has no other direct or indirect interest or relationship that could reasonably influence their judgement and decision making as a director |
| Issuer | any entity that has issued securities to the public. Issuers include some statutory bodies in the public sector that issue securities. |
| Listed issuer | an entity with securities quoted on New Zealand Exchange Limited. |
| Non-executive director | a director who is not an employee of the entity. |
| NZX | New Zealand Exchange Limited |
| Publicly owned entity | any entity that has shareholders (as defined below) that are members of the public. This includes companies and collective investment schemes that are widely held. |
| Shareholder | a person who owns shares in a listed or unlisted company, or<br>a person who owns an interest in a collective investment scheme where they have rights, similar to those of a shareholder in a company, to participate in the assets of the entity on winding up and to vote on some issues regarding the entity. |
| Stakeholder | in relation to an entity, any person or group other than shareholders that is affected by the affairs of the entity. |
| Substantial shareholder | a person who has a relevant interest in 5% or more of the voting securities of an entity, as defined in the Securities Markets Act 1988. |

# The Principles in context

These Principles are intended to contribute to high standards of corporate governance in New Zealand entities. This will be achieved when directors and boards implement the Principles through their structures, processes, and actions, and demonstrate this in their public reporting and disclosure.

**Developing the Principles**

The Commission's consultation process in 2003 sought to identify the level of consensus within New Zealand around:

1. What a set of governance Principles should encompass;
2. The range of issues that need to be reflected in the Principles;
3. The range of entities to which the governance Principles should apply.

Responses indicated a high level of consensus on these broad issues, although opinions often varied on questions of detail.

The public views from our consultation have helped develop these corporate governance Principles. As well, the Commission has been assisted by other work done in New Zealand, in particular by New Zealand Exchange Limited, the Institute of Directors in New Zealand, and the Institute of Chartered Accountants of New Zealand. We also researched international developments, particularly those from the OECD, and in Australia, the United Kingdom, and the United States.

This work has led to Principles which are consistent with international practice and reflect the views of most people who took part in the project.

**Applying the Principles**

A solid international body of empirical research supports the argument that fundamental aspects of corporate governance can play a key role in corporate performance. This has been demonstrated in recent work by the OECD, assessing implementation of its 1999 corporate governance principles. This should make improved governance a priority for all corporate entities.

Accordingly, the Commission has developed these Principles to be generally applied to the governance of entities that have economic impact in New Zealand or are accountable, in various ways, to the public. This includes listed issuers, other issuers, state-owned enterprises, community trusts, and public sector entities. However, not all of the Principles will apply entirely to all entities. Public sector organisations, for instance, do not have shareholders in the traditional sense, and are subject to specific board appointment processes. They nonetheless have an owner and are accountable to that owner, and to other stakeholders and the public. These entities should observe the Principles to the fullest extent that they reasonably can and depart only where they are subject to competing statutory or public policy requirements.

The Principles recognise that different types of entities can take different approaches to achieving good corporate governance. Good governance practices should reflect the nature of each entity, its ownership structure, and the range and interests of stakeholders.

**Implementation of the Principles by issuers**

The Commission's primary focus, arising from its statutory functions, is on issuers of securities – those entities who raise or have raised investment money from the public. Issuers are a diverse group including some private companies, Crown-owned entities, and local authorities as well as entities listed on NZX's markets. The Principles are consistent with the NZX Corporate Governance Best Practice Code and the Listing Rules.

Issuers are entrusted with money invested with them by the public. All issuers have a responsibility to their investors to pay close attention to corporate governance practices with a view to achieving high standards of corporate performance and accountability. Such standards can in turn contribute to confidence in our capital markets.

Particular attention has been paid to publicly owned entities. By this we mean public companies and other entities, such as some collective investment schemes, which have investors with similar ownership interests to company shareholders, and similar rights to vote on matters affecting the entity. For the purposes of this document we have used the term "shareholders" to include these investors.

Publicly owned entities are entities where ownership is held by many people, but the control of the entity is the responsibility of the board. In these circumstances it can be very difficult for the large number of owners to hold the directors to account. This problem can be reduced when directors observe governance practices that promote the interests of the owners of the entity.

We consider the Principles can be applied by investment trusts and participatory schemes as well as by other corporate issuers. They should also be useful to trustees and statutory supervisors who supervise schemes and scheme managers.

The Principles do not impose any new legal obligations on issuers. However, they set out standards of corporate governance that the Commission expects boards of issuers to observe and to report on to their investors and other stakeholders.

Most of the Commission's published reports on market behaviour reveal shortcomings that can be attributed to corporate governance failures. The Commission will continue to focus strongly on corporate governance in its enforcement work. We will comment or take other action where we find examples of poor governance. Any serious case may be referred to the Registrar of Companies to consider prosecution or prohibition from acting as a director.

**The guidelines**

Guidelines are included which set out structures and processes to help issuers to achieve each Principle. Some guidelines are addressed specifically to publicly owned entities and other issuers. Others can be used by all entities.

The guidelines do not detract from our view that different entities can find different ways to achieve good corporate governance. Some of the guidelines may not suit particular issuers for such reasons as size, board composition, or cost. Directors and executives will be best placed to decide the detail of structures and processes for implementing the Principles for any given entity.

**The governance environment**

The Commission published a statement on corporate governance in November 2002. This briefly covered many issues that are more fully dealt with in these Principles. It also commented on the regulatory environment that will encourage good governance by issuers.

Although the Principles are primarily for boards and directors, others also have an important role in maintaining high standards of corporate governance and investor confidence. In particular the professional advisers to entities – lawyers, accountants, and others – have significant responsibilities. By law directors are entitled, in certain circumstances, to rely on the advice of professionals. This is entirely appropriate, but places a burden on advisers in terms of their conduct and accountability. Ultimate responsibility under the law for good corporate governance lies with boards and directors.

Regulators and the regulatory environment also have a role in encouraging good corporate governance. The Commission takes this responsibility seriously and will pay close attention to the corporate governance of those entities for which we have jurisdiction.

**Auditor oversight**

Various accounting scandals overseas have increased the focus on auditors and audit performance. Internationally, confidence in auditors has been shaken.

New Zealand is unusual in that it does not have a body, independent of the audit profession, responsible for the oversight of auditors. There was not strong support for such a body from the consultation. However, the Commission considers that independent oversight of auditors would contribute to confidence in audit quality and in particular auditor independence.

This would also contribute positively to the integrity of our capital markets, particularly as they are perceived by international investors. It would bring New Zealand into harmony with other jurisdictions including Australia, the United Kingdom, and the United States.

The Commission will recommend that the Government take steps to achieve this.

# How to use this document

### Principles and guidelines

In its consultation documents the Commission identified nine areas of corporate governance important to New Zealand. The public response endorsed these nine issues and accordingly a principle has been developed for each. Consequently this document is in nine sections, each with four parts.

1. *The Principle* – the high level objective which all entities should aim to achieve in each area of corporate governance. Entities should report on how they have achieved each of the Principles.

2. *Guidelines* - structures or processes intended to help entities achieve each Principle. Some guidelines are more suited to certain types of entity, some to all entities. They are suggested ways of achieving the Principles. However, entities need not report against each guideline, including if the relevant Principle is achieved in another way.

3. *Key findings from consultation* - the main points expressed by respondents to the consultation.

4. *Securities Commission View* - the Commission's view on the issue, and the rationale behind the Principle and guidelines.

### The Appendix

The Appendix describes the public consultation process and provides a detailed analysis of the responses to our consultation.

# How to report against the Principles

**All entities**

The Commission's recommended approach for corporate governance depends heavily on disclosure of corporate governance practices by entities. Implementing the Principles necessarily includes reporting about corporate governance practices to shareholders and other stakeholders. For most entities this can be achieved in the annual report.

Many responses to our consultation commented that a "tick-in-the-box" approach to governance reporting would not achieve anything. We agree. The Principles are formulated so that entities can report *how* they have achieved each Principle.

This reporting is likely to include a brief description of the structures and processes put in place by the board to help it fulfil its governance responsibilities, and how it has used them.

The guidelines are intended to help entities to think about how they can achieve each Principle. We do not expect entities to specifically report against these guidelines. Reporting should describe how an entity has achieved the Principles.

**Listed issuers**

Listed issuers who have high standards of corporate governance are likely to address already all the issues covered by the Principles, both by adopting certain practices and by reporting on them. They report on these under NZX Listing Rule 10.5.3(h), which requires annual reports to include "*a statement of any corporate governance policies, practices and processes, adopted or followed by the Issuer*". For the many listed issuers whose governance practices and reporting are already of a high standard, adopting the Principles is unlikely to impose any new requirements or additional reporting.

However, listed issuers whose reporting under Listing Rule 10.5.3(h) does not cover all the corporate governance areas of the Principles should, we think, examine their corporate governance practices with a view to adopting and reporting on all of the Principles.

The Principles therefore do not impose a dual reporting regime.

Listed issuers have continuous disclosure obligations under Listing Rules. Proper observance of corporate governance is an important contributor to transparency and efficiency in the capital markets. Some matters relevant to corporate governance could be "material information" that must be disclosed under the Listing Rules of NZX. Nothing in this document about the content of annual reports should be taken to detract from any obligation a listed issuer has to disclose a matter under the continuous disclosure Listing Rules.

Formal corporate governance reporting may be new to some smaller unlisted entities. The Commission believes that all entities should think about their corporate

governance practices; however we are aware that it may take time for some smaller entities to achieve and report against all the Principles. In the meantime we think it would be helpful for these entities to report to their investors and stakeholders on progress made towards observing and reporting on each Principle.

**A note to shareholders and other users of annual reports**

Disclosure is important because it makes entities more accountable to their shareholders and other stakeholders. However, there are two sides to this and the users of this disclosure have a significant role. For disclosure to be effective, shareholders, investors, and other stakeholders need to evaluate the information they are given and, on this basis, responsibly call directors and executives to account.

The Commission expects issuers to tell investors how they have achieved each Principle. There are a variety of ways in which any entity may achieve the Principles. It may or may not include adopting the guidelines in this document. The guidelines are not ends in themselves. They also may not be ideal for every entity to which we think they could apply. Therefore, where we have provided guidelines for any type of entity, it is open to that entity to take a different approach. Shareholders and other investors should give due weight to the entity's reporting of how it has achieved the relevant Principle, and take a common sense approach to deciding whether or not they accept it.

# Principles for Corporate Governance

- **Directors should observe and foster high ethical standards.**
- **There should be a balance of independence, skills, knowledge, experience, and perspectives among directors so that the board works effectively.**
- **The board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility.**
- **The board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs.**
- **The remuneration of directors and executives should be transparent, fair, and reasonable.**
- **The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.**
- **The board should ensure the quality and independence of the external audit process.**
- **The board should foster constructive relationships with shareholders that encourage them to engage with the entity.**
- **The board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose.**

# Principles and Guidelines

## 1. Ethical Standards

### Principle

Directors should observe and foster high ethical standards.

### Guidelines

1.1 The board of every entity should adopt a written code of ethics for the entity that sets out explicit expectations for ethical decision making and personal behaviour in respect of:

- conflicts of interest, including any circumstances where a director may participate in board discussion and voting on matters in which he or she has a personal interest;
- proper use of an entity's property and/or information; including safeguards against insider trading in the entity's securities;
- fair dealing with customers, clients, employees, suppliers, competitors, and other stakeholders;
- giving and receiving gifts, facilitation payments, and bribes;
- compliance with laws and regulations; and
- reporting of unethical decision making and/or behaviour.

1.2 Every code of ethics should include measures for dealing with breaches of the code.

1.3 Every entity should communicate its code of ethics to its employees and provide employee training. Whistleblowing procedures should be provided.

1.4 Every board should have a system to implement and review the entity's code of ethics. The board should monitor adherence to the code and hold directors, executives, and other personnel accountable for unethical behaviour.

1.5 Every entity should publish its code of ethics. Annual reports should include information about the steps taken to implement the code and monitor compliance, including as appropriate any serious instances of unethical behaviour and the action taken.

### Key findings from consultation

- Ethical conduct is the basis of good governance.
- Companies should have a code of ethics.
- Generally, codes of ethics should be published.

- Generally, codes should address issues of integrity, conflicts of interest, confidentiality, and the use of company assets and resources including company information.
- Companies should have policies and procedures to deal with code breaches.

## Securities Commission view

Ethical behaviour is central to all aspects of good corporate governance. Unless directors and boards are committed to high ethical standards and behaviours, any governance structures they have put in place will not be effective.

Good governance structures can encourage high standards of ethical and responsible behaviour. A formal code of ethics will assist in this when it is understood by directors and management and applied to their governance decision making.

Codes of ethics are increasingly being adopted by listed issuers. More widespread adoption and implementation of codes of ethics will help bring New Zealand into line with international best governance practice and will promote public confidence in governance structures and behaviours generally.

Different businesses face specific ethical issues. A code of ethics needs to suit the particular circumstances and needs of the entity, and to be formulated with this in mind.

Codes of ethics can vary for different types of entity to address the circumstances of each entity's business. However, some common ethical issues arise in every entity that is accountable to shareholders, investors, and other stakeholders. It is our view that at a minimum a code of ethics should address the matters set out in the guidelines above. Depending on the entity there may be other matters that it is appropriate to include. As circumstances change, codes of ethics may need to be expanded or updated to ensure that they remain relevant.

The existence of a code of ethics will not, alone, create ethical and responsible practices. A code is a guide and reminder of expected behaviours and sets standards against which behaviours can be judged. A code is ineffective unless directors and employees actively adhere to it. The board will need systems in place to allow it to oversee implementation of the code. A code is not fully implemented unless there is monitoring to evaluate practices against the code. This could form part of the board's annual performance assessment.

There is a trend overseas for entities to have an ethics committee to assess the performance of directors against the code of ethics. Some entities go as far as seeking independent verification, on a periodic basis, of the implementation of codes of ethics. Some entities may find this appropriate. Ultimately the board is responsible for ethical behaviour within the entity.

A code of ethics will not be effective unless there are consequences for directors and employees who breach it. An effective code of ethics will set out processes for holding individuals accountable for unethical behaviour and include appropriate

sanctions. Accountability for behaviour at variance to the code will depend on who has committed the breach, e.g., executives to the board and other personnel to executives.

Transparency encourages ethical behaviour by increasing the accountability of directors and other personnel. This accountability will be enhanced if entities publish their codes of ethics for investors and stakeholders, and describe in their annual reports the steps taken to implement the code and monitor compliance. We are of the view that this reporting should include, in general terms, information about any serious instances of unethical behaviour encountered within the entity, and the steps taken to deal with this.

## 2. Board composition and performance

### Principle

There should be a balance of independence, skills, knowledge, experience, and perspectives among directors so that the board works effectively.

### Guidelines

2.1. Every issuer's board should have an appropriate balance of executive and non-executive directors, and should include directors who meet formal criteria for "independent directors".

2.2. All directors should, except as permitted by law and disclosed to shareholders, act in the best interests of the entity, ahead of other interests.

2.3. Every board should have a formal charter that sets out the responsibilities and roles of the board and directors, including any formal delegations to management.

2.4. The chairperson should be formally responsible for fostering a constructive governance culture and applying appropriate governance principles among directors and with management.

2.5. The chairperson of a publicly owned entity should be independent. No director of a publicly owned entity should simultaneously hold the roles of board chairperson and chief executive (or equivalent). Only in exceptional circumstances should the chief executive go on to become the chairperson.

2.6. Directors should be selected and appointed through rigorous, formal processes designed to give the board a range of relevant skills and experience.

2.7. Directors should be selected and appointed only when the board is satisfied that they will commit the time needed to be fully effective in their role.

2.8. The board should set out in writing its specific expectations of non-executive directors (including those who are independent).

2.9. The board should allocate time and resources to encouraging directors to acquire and retain a sound understanding of their responsibilities, and this should include appropriate induction training for new appointees.

2.10. The board should have rigorous, formal processes for evaluating its performance, along with that of board committees and individual directors. The chairperson should be responsible to lead these processes.

2.11. Annual reports of all entities should include information about each director, identify which directors are independent, and include information on the board's appointment, training and evaluation processes.

## Key findings from consultation

- An independent director has no relationship with the company that could compromise his or her ability to exercise unfettered judgment.
- An independent director should not be a substantial shareholder in, a material customer of, or a material supplier or professional adviser to, the company.
- Opinion was divided on whether independent directors should make up the majority of boards.
- Boards should have members who bring the skills and experience needed for the governance of the particular entity.
- Board size should be determined by factors including the size and complexity of the company and the skills and experience needed to govern it.
- The CEO should not be the chairperson nor go on to be the chairperson.
- Boards should review their performance yearly.
- Boards should review the performance of individual directors.
- More could be done to enable shareholders to assess board performance.
- Opinion was divided on whether directors should be certified or accredited.
- Entities should have recruitment and induction programmes for directors.

## Securities Commission view

The board must guide the strategic direction of the entity, and direct and oversee management. Each director must have skills, knowledge and experience relevant to the affairs of the entity. Individual directors may bring particular attributes that complement those of other directors. An effective board requires a range and balance of relevant attributes among its members. Each director must be able and willing to commit the time and effort needed for the position.

Independence of mind is a basic requirement for directors. Each should endeavour to have an independent perspective when making judgements and decisions on matters before the board. This means a director puts the interests of the entity ahead of all other interests, including any separate management interests and those of individual shareholders (except as permitted by law). Directors with an independent perspective are more likely to constructively challenge each other and executives—and thereby increase the board's effectiveness.

Non-executive directors, with no other interests to hinder their judgement in the interests of the entity, can contribute a particularly independent perspective to board decisions. Increasingly, international practice has been to establish criteria for defining some independent directors of listed entities, and to require or encourage a majority of such directors on the board. Recent studies indicate, however, that board effectiveness is not always enhanced by directors' formal independence if this is given too much weight in contrast to the independence of mind, and the skills,

knowledge, experience, and time that a director can contribute to the entity. Independent representation is an important contributor to board effectiveness, but only when considered along with the other attributes sought in a non-executive director.

As reflected in the consultation, there may be practical constraints in New Zealand if too high a level of formal independence is required of boards. With New Zealand's relatively small pool of qualified and experienced directors there is a risk that seeking independence at the cost of all else will lead to missed opportunities to appoint directors who can contribute to the success of entities. We consider the underlying issues relating to director independence can be addressed by:

- Directors having an independent perspective in their decision making;
- A non-executive director being formally classified as independent only where he or she does not represent a substantial shareholder and where the board is satisfied that he or she has no other direct or indirect interest or relationship that could reasonably influence their judgement and decision making as a director;
- The chairperson of a publicly owned entity being independent.
- In every issuer, the board including independent director representation.
- Boards of publicly owned entities comprising
  - a majority of non-executive directors; and
  - a minimum one third of independent directors.
- Boards taking care to meet all disclosure obligations concerning directors and their interests, include information about the directors, and identify which directors are independent.

It is important to recognise the contribution of executives: the skills and perspectives they have provide a sound basis for challenge by non-executive directors. Strong executive representation at board meetings or on boards promotes a constructive exchange between directors and executives that is necessary for boards to be effective. To maintain proper balance between executive and non-executive directors, it can be useful for the latter to meet regularly to share views and information without executives present.

Efficiency and accountability are improved if the respective roles of the board and executives are well understood by all. This can be assisted by the adoption of a board charter that sets out the responsibilities of the board and its directors and that includes details of any delegations given by the board to management.

Directors are entitled to seek independent advice. This may be necessary to fully inform themselves about an issue before the board, and to effectively contribute to board decisions.

The chairperson is critical in director-executive relations. The chairperson's role includes promoting co-operation, mediating between perspectives, and leading informed debate and decision making by the board. The chairperson also has a pivotal role between the CEO and the board. Balance in the relationship between management and the board is particularly important in entities with public

shareholders. This balance is facilitated if the roles of chairperson and chief executive (or equivalent) are clearly separated and if the chairperson is an independent director. We agree with respondents to the consultation that in general, the chief executive should not move on to become chairperson. Only in special circumstances should the roles be combined, e.g. where an individual has skills, knowledge and experience not otherwise available to the entity (and where these circumstances are fully explained to investors).

The optimum number of directors for any entity will depend on its size and the nature and complexity of its activities, as well as its requirement for independent directors. If a board is too large, decision making becomes unwieldy; if too small, it may not achieve the necessary balance of skills, knowledge and experience needed by the entity. This balance is most important for issuers.

The need to achieve the right mix, and to choose directors who can make an appropriate contribution, make director selection and nomination vitally important. Rigorous selection, nomination and appointment processes are needed to achieve this. A separate nomination committee can help to focus resources on this task, and also on succession planning.

Non-executive directors often do not have the advantage of prior knowledge of an entity. This makes it important that they clearly understand their expected roles within the entity. It will be of value for a new director if the board sets out its expectations of his or her role.

To be individually effective, directors need to make themselves familiar with both the activities of the entity and their responsibilities as a director. Induction training and opportunities to attend directors' professional education can greatly assist this process.

Effectiveness can also be enhanced if the board and directors regularly assess their own performance and that of their individual members against pre-determined measures of the efficiency and effectiveness of board processes, and on the contributions of individual directors. The Commission would like to see each board develop its own review and report processes as an integral element of its focus on good governance.

# 3. Board Committees

## Principle

The board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility.

## Guidelines

3.1 Every board committee should have a clear, formal charter that sets out its role and delegated responsibilities while safeguarding the ultimate decision making authority of the board as a whole.

3.2 Where issuers have board committees, the charter and membership of each should be published for investors.

3.3 Proceedings of committees should be reported back to the board to allow other directors to question committee members.

3.4 Each publicly owned company should establish an audit committee of the board with responsibilities to: recommend the appointment of external auditors; to oversee all aspects of the entity-audit firm relationship; and to promote integrity in financial reporting. The audit committee should comprise:

- all non-executive directors, a majority of whom are independent;
- at least one director who is a chartered accountant or has another recognised form of financial expertise; and
- a chairperson who is independent and who is not the chairperson of the board.

## Key findings from consultation

- Board committees set up for specific purposes can improve effectiveness, however boards should retain responsibility for policy and governance.
- Public companies should have audit committees to appoint and oversee external auditors.
- Audit committees should have an independent chairperson and a majority of independent directors.
- Audit committees should have at least one member with financial expertise.
- Large boards should have a remuneration committee.
- Opinion was divided on the need for appointment committees.
- Remuneration and appointment committees should have a majority of independent directors.
- A person should be able to sit on both the remuneration committee and the audit committee.

## Securities Commission view

Board committees can significantly enhance the effectiveness of the board through closer scrutiny of issues and more efficient decision making in key areas of board responsibility. Committees enable the board to make maximum use of particular skills, knowledge and experience of directors. In addition, they can be a means of fairly apportioning board workload among directors.

A committee must have an effective relationship with the board as a whole. Committee members must clearly understand the committee's purpose and role and the extent of any formal delegations from the board. A clear, formal committee charter agreed by the board is an efficient way to achieve this. Disclosing the charter and information on the composition and work of committees will assist investors and stakeholders to assess the effectiveness of board committees.

The accountability of the board as a whole must be maintained, including in relation to work undertaken by committees. The board must be well informed about decisions for which it retains ultimate responsibility. For this reason it is important that the proceedings of committees are reported back to the board, and time is given for any director who is not on the board to comment on or seek an explanation of the business of the committee.

Financial reporting and audit processes are a key area of board responsibility. It is increasingly common practice in New Zealand and internationally for entities to use audit committees. We believe they are an important tool for all publicly owned entities, and we would encourage their use by all issuers.

As with other committees, the role of the audit committee needs to be clearly established. This can be achieved by a formal charter, including responsibility for recommending the appointment of external and internal auditors; overseeing the entity-auditor relationship; and promoting the integrity of the entity's financial reporting.

The structure of the audit committee is important, both in terms of independence and the skills needed. To ensure effectiveness, it should comprise:

- only non-executive directors;
- a majority of independent directors;
- at least one director who is a chartered accountant or has another recognised form of financial expertise; and
- a chairperson who is an independent and is not the chairperson of the board.

Other areas of board performance could also be improved by the use of committees. Remuneration and nomination committees are increasingly being used in New Zealand and overseas. It is vital that boards give proper time and attention to both matters. All entities, particularly those with large boards, should carefully consider whether the use of committees could enhance their effectiveness in these key areas.

# 4. Reporting and Disclosure

## Principle

The board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs.

## Guidelines

4.1 All boards should have a rigorous process for assuring directors of the quality and integrity of entity financial reports including their relevance, reliability, comparability, and timeliness.

4.2 Annual reports of all entities should, in addition to all information required by law, include sufficient meaningful information to enable investors and stakeholders to be well informed on the affairs of the entity.

4.3 All issuers should have an effective system of internal control for reliable financial reporting.

4.4 The chief executive, the chief financial officer (or equivalent officers), and at least one other director of publicly owned entities should certify in the published financial reports that these comply with generally accepted accounting standards and present a true and fair view of the financial affairs of the entity.

4.5 Each listed entity should have a clear and robust internal process for compliance with the continuous disclosure regime, which should include board examination of continuous disclosure issues at each board meeting.

4.6 Every entity should make its code of ethics, board committee charters and other standing documents important to corporate governance readily available to interested investors and stakeholders.

4.7 Boards of issuers should report annually to investors on how the entity is implementing the Principles and explain any significant departure from guidelines supporting each Principle.

## Key findings from consultation

- Companies should report on their performance against governance principles.
- No obvious gaps were identified in the current disclosure requirements for listed companies.
- Unlisted companies with public shareholders should improve disclosure.

- Opinion was divided on the need for other unlisted companies to disclose more information than they do now.
- Listed companies should not be required to report quarterly.
- CEOs and CFOs should publicly sign off financial statements.
- Auditors, audit committees, and enforcement of reporting requirements are important safeguards.
- Reports should be easy to understand.

## Securities Commission view

High standards of reporting and disclosure are essential for proper accountability between an entity and its investors and stakeholders. Accountability is a principal incentive for good corporate governance. Reporting and disclosure encompasses both financial reporting and reporting on other affairs of the entity, including corporate governance structures, processes, and actions.

The quality and integrity of financial reports are reflected in their relevance, reliability, and comparability, and in how understandable they are for users. Other disclosures must be balanced and timely. Legal and regulatory requirements, including the NZX Conduct Rules, establish baseline expectations for reporting and disclosure. Good corporate governance includes compliance with these requirements and a commitment to ensuring that investors, stakeholders, or the recipients of public sector reports are sufficiently informed to allow them to assess the entity and the board.

The board is directly responsible for the integrity of financial reports. This requires internal controls and processes to enable directors to satisfy themselves of the quality of financial reporting. The audit committee (see 3.) and independent auditors (see 7.) make a major contribution. These processes should include certification by the chief executive and the chief financial officer (or equivalent officers). These executives are principally accountable to directors on whom there is already well-established responsibility for financial reports. We see this accountability further strengthened, especially in publicly owned entities, by the CEO and CFO publicly demonstrating their responsibility by certifying the financial statements. While directors retain liability for the financial statements of an entity, they will to a degree rely on management assurances about the accuracy and completeness of financial reports. In view of this, an added public certification by the responsible executives will enhance investor confidence in the entity.

Reporting and disclosure requirements are of most significance for public sector entities and for issuers and listed entities, consistent with current law. However, other entities could adopt similar standards in the form and timeframe that best suits their legal form, types of business, stage of development, and also the range of users of their financial reports. We encourage all issuers to see listed entity reporting and disclosure as best practice in the New Zealand environment, to the extent applicable. All entities that have raised money from the public should report to investors on the entity's goals, strategies, position, and performance.

The continuous disclosure regime is a major contributor to higher standards of information disclosure in the listed issuer sector. The immediacy of continuous disclosure requires that boards of listed issuers have processes to raise awareness throughout the entity of the obligations of disclosure, and efficient channels to alert management of matters that may require disclosure. Compliance with continuous disclosure is a board responsibility, and the processes should ensure that continuous disclosure compliance is placed on the agenda of board meetings.

The principles-based approach to corporate governance relies on meaningful disclosure. Reporting should not be by "tick-in-the-box". It should involve boards saying *how* they have implemented each Principle, i.e., the actions they have taken that suit the legal form, business type and stage of development of the entity. Describing governance structures and behaviours in this way will enable investors and stakeholders to make an informed assessment of the governance of the entity. The disclosure process can also be used as a facilitation process to assist the board in its assessment of the entity's processes and internal control.

# 5. Remuneration

## Principle

The remuneration of directors and executives should be transparent, fair, and reasonable.

## Guidelines

5.1 The board should have a clear policy for setting remuneration of executives (including executive directors) and non-executive directors at levels that are fair and reasonable in a competitive market for the skills, knowledge and experience required by the entity.

5.2 Publicly owned entities should disclose their remuneration policy in annual reports.

5.3 Executive (including executive director) remuneration should be clearly differentiated from non-executive director remuneration.

5.4 Executive (including executive director) remuneration packages should include an element that is dependent on entity and individual performance.

5.5 No non-executive director should receive a retirement payment unless eligibility for such payment has been agreed by shareholders and publicly disclosed during his or her term of board service.

## Key findings from consultation

- Opinion was divided over whether all directors' remuneration should be linked to company performance.
- Linking remuneration to company performance risks directors taking a short-term rather than a strategic view.
- Fees paid to non-executive directors may be too low to attract and retain the right people.
- Opinion was divided over whether a portion of non-executive directors' remuneration should be in shares or options and whether they should be paid retirement benefits.
- CEO and senior management remuneration should be disclosed.
- Executive remuneration should not be subject to shareholder approval.

## Securities Commission view

Adequate remuneration is necessary to attract, retain and motivate high quality directors and executives. Such remuneration, it is generally expected, will be reflected in enhanced entity performance. To some extent, remuneration can also be a means of sharing with directors and executives the financial rewards and risks of good or poor performance.

The issues in establishing remuneration are particularly complex and can only be viewed in the context of each entity. It is important that every board has policies and processes for setting remuneration and for remuneration reporting (including disclosures required under the Companies Act 1993).

Shareholders of a publicly owned company have a particular interest in seeing that the remuneration policy will attract the right directors, and that the level of remuneration is reasonable. To enable shareholders to assess this, the policy for determining remuneration must be disclosed, as well as the total remuneration and other benefits paid to directors.

Executive and non-executive directors have different roles and different incentives. Drawing a clear distinction between the remuneration packages of executive directors and non-executive directors allows entities the flexibility to properly address the circumstances of both.

If a part of executive directors' remuneration is related to entity performance over time, their efforts are more likely to be focused on making a contribution to future investor returns rather than only on short term gains. Such remuneration may include shares or options.

Non-executive directors' remuneration is usually by way of fees. Again it is important for accountability of publicly owned entities that all benefits received are disclosed to shareholders. It is consistent with this transparency that non-executive directors should not receive retirement payments except where eligibility for such payments has been agreed and disclosed during the term of service on the board, and in the case of publicly owned entities, where shareholders have been asked to approve these payments.

Some entities, particularly those with larger boards, may benefit from appointing a remuneration committee to make recommendations on remuneration for executive directors and other executives. Where shares or options are part of performance-related remuneration, the committee can recommend to the board (or have delegated responsibility for) an appropriate approach to valuation and disclosure.

# 6. Risk Management

## Principle

> The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.

## Guidelines

6.1 The board should require the entity to operate rigorous processes for risk management and internal control.

6.2 The board should receive regular reports on the operation of risk management and internal control processes.

6.3 Boards of issuers should report annually to investors and stakeholders on risk identification and management and on relevant internal controls.

## Key findings from consultation

- Entities should have risk management policies.
- Financial, market, operational, and environmental risks, delegations, and succession planning should be included in risk management policies.
- Opinion was divided on whether risk management policies should be published.
- Risk management policies and procedures should be monitored and regularly reviewed.
- Focus on risk should not stifle business.

## Securities Commission view

Risk is an essential feature of business. Each entity is faced with a range of risks that it needs to identify and manage (or avoid). Accordingly, risk management is a critical area of responsibility for the board. Boards can only be effective if they know of, and can properly assess, the nature and magnitude of risks faced by the entity. Effective risk management can enable an entity to take the risks appropriate to its business.

Processes to identify, monitor and manage risks are needed so that the board and managers can be properly informed and can implement systems of internal control that are responsive to the identified risks. These processes will usually operate alongside the internal control structures of the entity. The size and circumstances of the entity and the particular risks it faces will help determine the best risk management processes for the entity. Effective processes will accommodate the types of risks that the entity is likely to face, including legal compliance, financial,

operational, technological, and environmental risks. An internal audit function can assist effective risk management and internal control in entities that face significant financial, operating, and compliance risks.

For issuers, disclosure of the nature and magnitude of material risks and how the board intends to manage these will be of significant benefit to investors, who need this information in order to make informed investment decisions. For other entities, disclosure of risk management policies may be useful where these affect specific stakeholders.

# 7. Auditors

## Principle

The board should ensure the quality and independence of the external audit process.

## Guidelines

7.1 The board should inform itself fully on the responsibilities of external auditors and be rigorous in its selection of auditors on professional merit.

7.2 The board should satisfy itself that there is no relationship between the auditor and the entity or any related person that could compromise the independence of the auditor, and should require confirmation of this from the auditor.

7.3 The board should facilitate full and frank dialogue among its audit committee, the external auditors, and management.

7.4 No issuer's audit should be led by the same audit partner for more than five consecutive years (i.e. lead and engagement audit partners should be rotated from the engagement after a maximum of five years).

7.5 Boards of issuers should report annually to shareholders and stakeholders on the amount of fees paid to the auditors, and should differentiate between fees for audit and fees for individually identified non-audit work (i.e., separating each category of non-audit work undertaken by the auditors, and disclosing the fees payable for this).

7.6 Boards of issuers should explain in the annual report what non-audit work was undertaken and why this did not compromise auditor independence.

## Key findings from consultation

- The role of auditors is important to good corporate governance.
- Rotation of audit firms should not be required.
- Audit partners should be rotated, preferably every five years.
- Auditors should not do work which could compromise their ability to produce independent audit reports.
- Disclosure of fees paid to audit firms should identify specific types of non-audit work.
- Non-audit work should not be capped to a specific proportion of all fees paid to an audit firm.
- Boards should have whistleblower policies and disclose them.
- An independent audit oversight body is not required.

## Securities Commission view

External auditing is critical for integrity in financial reporting. To properly perform their role, auditors must observe the professional requirements of independence, integrity, and objectivity. They need to have access to all relevant information and individuals within an entity that play a role in its financial reporting processes.

The board and the auditors are jointly responsible for ensuring that an entity's audit is conducted in the context described above. Good governance requires structures that promote auditors' independence from the board and executives, protect auditors' professional objectivity in the face of other potential pressures, and facilitate access to information and personnel.

The board audit committee has a crucial role in selecting and recommending board and shareholder appointment of auditors, and in overseeing all aspects of their work.

Rotation of auditors is important to promote independence and objectivity over time. However, the advantages of this need to be balanced against the costs that are necessarily incurred when a new auditor is engaged. International practice strongly favours rotation of audit partners rather than audit firms. Although independence would be maximised by rotating audit firms, there are practical impediments and efficiency losses incurred by doing this.

When an audit firm commences a new audit engagement, costs associated with the audit are necessarily higher until the auditor becomes familiar with the entity and its business. Retaining a degree of continuity of auditors will increase the entity-specific knowledge that can be bought to bear in the audit process. Five yearly partner rotation provides a balance between cost and efficiency losses and independence gains, and is in line with international best practice.

Limiting non-audit work that an accounting firm can do for the client entity will help maintain independence and objectivity. There is a diversity of views in New Zealand and internationally on the types of non-audit work that should be restricted, and how this should be done. One core measure is that an accounting firm should not undertake any work for an audit client that compromises, or is seen to compromise, the independence and objectivity of the audit process. Given this measure, and within the framework of relevant legislation and professional standards, boards need to consider this question in the context of their entity. The quantum of fees paid for non-audit work will be a factor in determining independence.

Auditor independence is crucially significant to investors, who rely heavily on this external assurance of an issuer's financial reporting. Boards must be accountable to investors where they allow auditors to undertake non-audit work. This accountability can be achieved by boards of issuers including in the annual report a statement as to why, in their opinion, any non-audit work performed does not impinge on the independence of the auditor. This must be accompanies by disclosure of all fees paid to the auditor, with various types of non-audit work separately identified. This

disclosure would be assisted by professional standards relating to disclosure of audit fees and other fees paid to audit firms.

The board audit committee has a crucial role where complaints arise in the auditor-client relationship, or in any other aspect of auditing. The committee should have a defined process for dealing with complaints from auditors, for example over access to relevant information held by management. The committee should also be open to the views of employees or others who believe auditor independence and objectivity is or might be compromised. This includes whistleblowing actions by individuals who act in good faith with respect to external and internal audit processes.

The Companies Act contains accountability mechanisms that allow auditors to report directly to shareholders where reappointment is not sought, or where the entity seeks to remove an auditor. The board is required to permit auditors to attend annual meetings and be heard. Accountability can be enhanced when boards ask auditors to attend shareholders' meetings and to allow shareholders an opportunity to ask appropriate questions of the auditors.

# 8. Shareholder Relations

## Principle

The board should foster constructive relationships with shareholders that encourage them to engage with the entity.

## Guidelines

8.1 Publicly owned entities should have clear published policies for shareholder relations and regularly review practices, aiming to clearly communicate the goals, strategies and performance of the entity.

8.2 Publicly owned entities should maintain an up-to-date website, providing:

- a comprehensive description of its business and structure;
- a commentary on goals, strategies and performance; and
- key corporate governance documents;
- all information released to the stock exchange (for listed entities), including reports to shareholders.

8.3 Publicly owned entities should encourage shareholders to take part in annual and special meetings by holding these in locations and at times that are convenient to shareholders.

8.4 The board should facilitate questioning of external auditors by shareholders during the annual meeting.

## Key findings from consultation

- Companies could improve dialogue with their shareholders.
- Companies should facilitate appropriate access by shareholders to auditors.
- Opinion was divided on whether institutional shareholders should always vote on shareholder resolutions.
- Opinion was divided on whether listed companies should publish a formal shareholder relations policy.
- Listed companies are reasonably good at providing shareholders with comprehensive and easily understood financial information.
- Other entities should provide more comprehensive public reporting.

## Securities Commission view

Shareholders are the ultimate owners of entities. In general, company shareholders have a right to vote on certain issues affecting the control and direction of their company. In this document we have used the term shareholders broadly to include people with an ownership interest in non-company entities where they have a similar right to vote on entity issues. The rationale for good shareholder relations applies equally whatever the legal form of the entity.

As owners of their entities, shareholders have important rights and functions in corporate governance. Certain matters are reserved for shareholder approval. Boards can take steps to facilitate appropriate shareholder involvement in such meetings and decisions. Entities will be better placed to attract the capital and support they need, and to demonstrate real accountability, if relations between entities and their shareholders are cooperative and mutually responsive.

Good governance requires structures and behaviour that promote good relations through effective communications between entities and their shareholders. Publicly owned entities in particular can enhance this relationship by having a policy for communicating with shareholders and for encouraging appropriate shareholder participation. Steps that can be taken include:

- allocating time and resources to providing clear, plain language explanations of performance, strategies and goals, and identified material risks in the annual and (for listed entities) half yearly reports;
- maintaining websites that have comprehensive up-to-date information on their operations and structures, and an archive of corporate governance documents, shareholder reports, and past announcements and performance data;
- increasing the use of electronic technologies to make information more accessible to shareholders and others, including (where requested) email for distribution of shareholder documents and for responding to questions;
- holding shareholder meetings in locations and at times that are convenient to shareholders, and if appropriate in view of the number and location of shareholders, encouraging participation by teleconference or webcast.
- clearly setting out resolutions for shareholder decision, and encouraging informed use of proxies; and
- providing ready access to auditors for shareholder questions at annual and special meetings.

Institutional shareholders have a vital role to play in corporate governance, by monitoring company performance. If a disclosure-based approach to maintaining corporate governance standards is to be effective, those with voting power in an entity need to make use of their rights to question and challenge the board's performance and its corporate governance practices. Boards can increase accountability by encouraging institutional shareholders to vote on resolutions. Such shareholders, and in particular fund managers who are themselves accountable to public investors, should disclose their voting policies and record to their clients and investors.

# 9. Stakeholder Interests

## Principle

> The board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose.

## Guidelines

9.1 The board should have clear policies for the entity's relationships with significant stakeholders, bearing in mind distinctions between public, private and Crown ownership.

9.2 The board should regularly assess compliance with these policies to ensure that conduct towards stakeholders complies with the code of ethics and the law and is within broadly accepted social, environmental, and ethical norms, generally subject to the interests of shareholders.

9.3 Public sector entities should report annually to inform the public of their activities and performance, including on how they have served the interests of their stakeholders.

## Key findings from consultation

- Shareholder interests are paramount but companies should consider the interests of other stakeholders.
- Stakeholder interests include employee, environmental, social, and economic matters.
- Public sector bodies have a wide range of stakeholder obligations set out in law.
- Opinion was divided over whether stakeholder interests should be dealt with by boards or by management.
- Companies should have policies about stakeholder interests.

## Securities Commission view

Each entity has stakeholders who contribute to their performance in different ways. Examples include employees, customers, creditors, suppliers, the community and others. Legal obligations and relevant social, ethical, and environmental factors need to be taken into account when considering the interests of stakeholders.

Stakeholder interests have a particular significance for public sector entities with a public good purpose. These entities operate on public funding, and need to pay careful attention to their public stakeholders. While the principal reporting of most

public sector entities is to the Crown, public accountability will be enhanced if they also report each year on how they have served the interests of their public stakeholders.

Company law requires directors to act in the best interests of the company (subject to certain exceptions). However, advancing the interests of other stakeholders such as employees and customers will often further the interests of an entity and its shareholders. There is a trend for listed companies to report on how they have affected their stakeholders.

Good corporate governance practices will generally benefit stakeholders. Relationships with significant stakeholders can be improved if they are addressed in specific policies which are disclosed and reported on to stakeholders. In general, we agree with the response to our consultation that managing stakeholder interests should be viewed as simply good business.

Appendix

# Corporate Governance in New Zealand

# Report on Findings from the Consultation Process

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## THE CONSULTATION PROCESS

The Securities Commission researched and drew together thinking on corporate governance from international and New Zealand research and practices. This work was published as *Corporate Governance in New Zealand – Consultation on Issues and Principles – Background Reference*. This document identified nine issues relating to corporate governance that are important for New Zealand. The accompanying *Questionnaire* was prepared by a specialist questionnaire design company to gather people's thinking on the issues identified in the *Background Reference*. Both documents were approved by the Commission. The documents were made available to the public from 8 September 2003 until 7 November 2003. The few completed questionnaires returned after 7 November 2003 were included in the analysis.

### Promoting the process

All interested parties were invited to take part and the process was promoted via:

*Direct invitation by mail out*
Invitations to participate, together with the *Background Reference* and *Questionnaire*, were addressed to the chairperson and directors of 261 listed and unlisted companies, the mayor and councillors of 86 local authorities, the chairperson and members of 21 district health boards and the chief executive or equivalent of 53 advisory firms, government agencies and associations and agencies.

*News media*
Chairperson Jane Diplock announced the documents would be available on 8 September 2003, and drew attention to the Commission's website. This was widely reported in the financial media.

*Website*
The consultation documents were published on the Commission's website on 8 September 2003. Some 900 people received a personal email linking them directly to the documents.

*Public awareness*
An advertising campaign during the last two weeks of September 2003 raised awareness of the process. The advertisements invited people to take part and advised them how to obtain the consultation documents. The campaign ran in The New Zealand Herald, The Dominion Post, The Press (Christchurch), the Otago Daily Times, The National Business Review and The Independent.

*Professional associations*
Briefings on the process were held with New Zealand Exchange Limited, the Institute of Directors in New Zealand Inc, and the Institute of Chartered Accountants of New Zealand. We approached editors of a range of professional associations' newsletters and various business publications to report the process. A good level of coverage was achieved.

*Discussion groups*
Discussion groups chaired by Commission Members were held in Christchurch, Wellington, Hamilton and Auckland during October and early November 2003. Personal invitations were sent to 211 people on boards and councils and senior positions in entities including listed and unlisted companies, local authorities, district health boards, Maori organisations, funds' managers and co-operative companies. In total, 71 people attended these 2-hour meetings and, with their permission, their opinions were recorded on the *Questionnaire*.

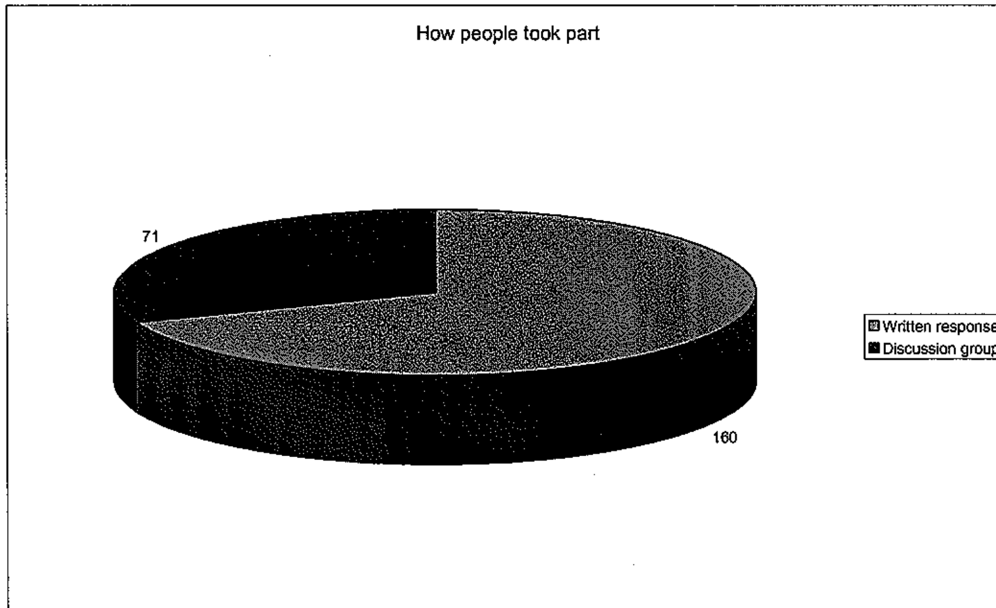
*Speeches*
Commission Members spoke on the consultation process at a number of forums, including meetings of the Institute of Directors in New Zealand Inc and seminars at Victoria University of Wellington.

## The response from participants

We were pleased with the level and quality of response to the discussion documents. Most questionnaires were completed by individuals but in other cases groups of people worked together to complete one questionnaire.

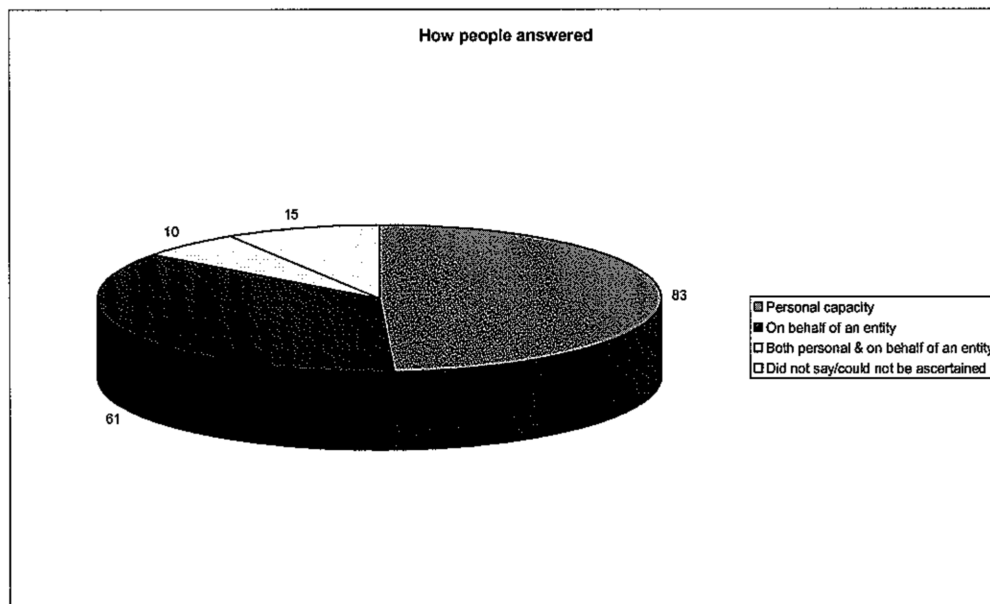
*How people took part*

160 written responses were received. 71 people participated in 9 discussion groups which generated a further 9 written responses.



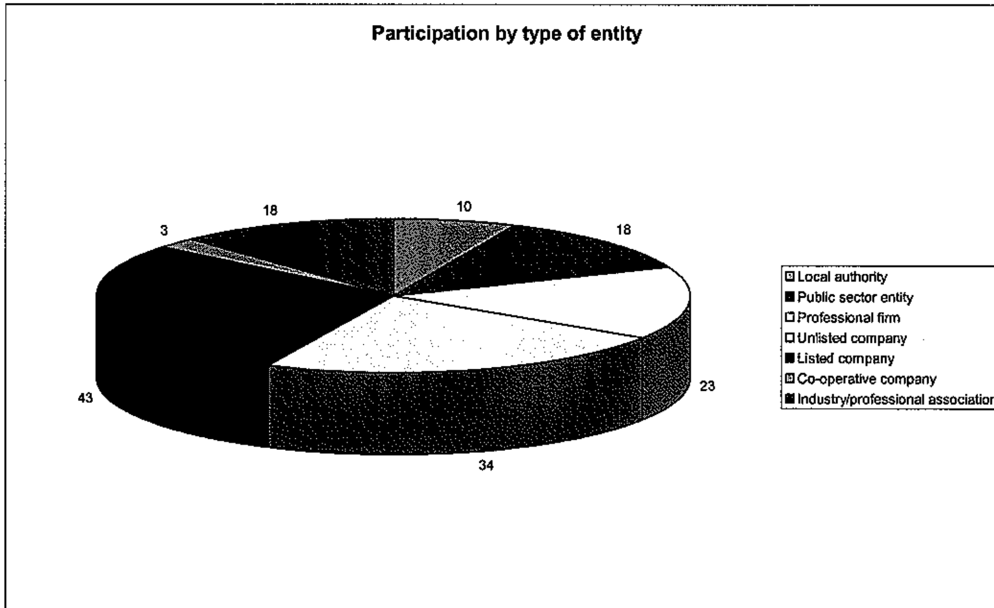

*How people answered?*

The questionnaire asked people about the capacity in which they were responding.



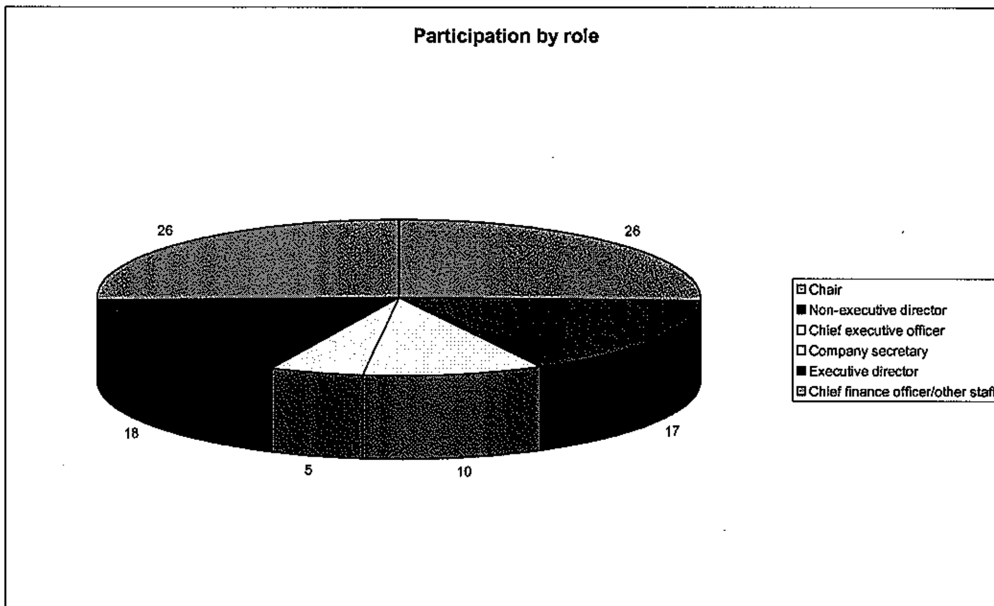
*Participation by type of entity*

Most of those who took part in the consultation indicated the type of entity that they were responding on behalf of, or with which they were associated. This showed participation across a range of business entities.




*Participation by role*

Many participants identified their role within an entity.



## Analysing the responses

The consultation process was a qualitative rather than quantitative exercise. Questions were open-ended and invited comment rather than asking respondents to choose one or more of a number of pre-determined options. It is not appropriate to tally responses, to apply percentages to particular points of view, or to assume that results necessarily represent the views of the entire business community. However, respondents identified with a good range of entities, and roles within entities.

Responses and respondents' details were recorded. Responses were entered into templates by Securities Commission staff and reviewed by external consultants. The submissions and feedback received were analysed on the basis of themes, trends and weight of opinion, rather than percentages or cross-tabulations. The Appendix (*Report on findings from the consultation process*) was subject to internal and external review.

While the conclusions reached may not reflect the specific views of individuals, every endeavour has been made to reflect the balance of opinion on the issues tested through the consultation process. We have included direct quotes from completed questionnaires in this Appendix as examples of the responses received on a particular question.

## Areas of broad agreement

*Principles-based approach*

Participants were asked whether a principles-based approach to corporate governance is most appropriate for New Zealand. Some jurisdictions have chosen a rules-based approach, while others (including Australia) have favoured a principles-based approach. In New Zealand there is strong support for a principles-based approach with a great majority of respondents favouring this.

> *"... a principles-based approach is much preferable to a rules-based approach. Apart from providing flexibility for adopting arrangements that suit the circumstances of the individual enterprise, companies must demonstrate that they have adhered to the spirit of what is espoused – whereas rules can be "got around" ... principles can be achieved at less cost due to the flexibility in methods used to measure or attain them."*

There were calls to avoid a prescriptive approach to applying the principles. Of the people who offered conditional support or disagreed with the proposition, some said a combination of a principles-based and rules-based approach might be needed.

*Core principles*

Respondents were asked whether the nine issues identified in the *Background Reference* are the core issues that should be included in New Zealand principles for corporate governance. They are:

*Ethical Conduct*
*Board Composition and Performance*
*Board Committees*
*Reporting and Disclosure*
*Remuneration*
*Risk Management*
*Auditors*
*Shareholder Relations*
*Stakeholder Interests*

A great majority agreed that the nine issues captured the core governance areas. Of those who gave conditional support or disagreed, some said communication and the integrity of directors are key to many of the issues.

*Common themes*
Some common themes emerged from the responses:

- Certain principles might be more relevant to some types of entities than others.
- Principles will need to be tailored to apply to New Zealand entities, especially smaller businesses.
- Company law determines many behaviours and there needs to be clarity around the role of the principles in guiding behaviour.

## Views by type of entity

Responses were analysed by type of entity to establish underlying trends. On the whole there are no clear "constituencies" of either agreement or disagreement by entity in relation to the issues raised in the questionnaire. There are some positions that professional firms and associations are more inclined to support, and some that companies are more inclined to support. However, given the qualitative nature of the research it would be inappropriate to infer too much from the conclusions in relation to type of entity. Any apparent trends or patterns are noted in the next section on consultation findings.

# THE FINDINGS FROM RESPONDENTS

## Issue One: Ethical Conduct

**Key findings from respondents**

- Ethical conduct is the basis of good governance.
- Companies should have a code of ethics.
- Generally, codes of ethics should be published.
- Generally, codes should address issues of integrity, conflicts of interest, confidentiality and the use of company assets and resources, including company information.
- Companies should have policies and procedures to deal with code breaches.

***Q: There is a view that companies should have formal codes of ethics or conduct to guide the actions of board and management, as well as other staff? To what extent do you agree with this?***

The great majority of respondents supported this. A typical response was that a code of ethics:

> *"should be considered best practice ... "*

Some qualified their support by commenting it should not be mandatory to have such codes. Others considered that codes may be appropriate only for listed companies, and may be unworkable for smaller, privately owned companies.

Some respondents suggested that codes be kept simple and should offer guidelines rather than rules, although several respondents stated a preference for more prescriptive codes. There was a view that it is not possible to legislate for ethical behaviour.

Some stated that an entity's culture, with management leading by example, is more important than a set of written principles. Some emphasised the need for careful selection of directors. Several considered that a code sets the tone of an organisation and raises awareness of ethical issues. Some people stressed that implementing a code of ethics is more important than the existence of a code. There was some support for individual entities preparing their own codes, while others supported a "standard" code which could meet the needs of a variety of entities.

Of those who disagreed, some noted that the Companies Act 1993 contains basic ethical obligations in the form of directors' duties, and that these should suffice. It was also suggested that a board charter is a more useful document, defining the governance responsibilities of the board and the demarcation of responsibilities between the board and management.

***Q: Should a code of ethics or conduct be published?***

A majority of respondents supported publishing codes, although there was a strong view that this should be at the discretion of the entities concerned. One respondent's comment summed this up saying:

> *"Publication internally in an organisation is useful in assisting consistent communication of a Code of Ethics or Conduct. Publication can also be useful to shareholders so they can gain an understanding of the ethics of their company. Each company needs to consider whether*

*the circumstances of its business mean that is worthwhile providing a published version of a code..."*

Some people commented that it may be appropriate to publish codes, or summaries of them (with full copies available on request), in annual reports and/or websites. This was considered more important for listed companies, state-owned enterprises and public sector bodies. Others considered that internal distribution would be sufficient.

The small number who disagreed with publishing codes said it was of limited meaning or value.

### *Q: Codes of ethics may address various issues including integrity, the use of company assets, conflicts of interest and confidentiality. What issues do you think it is most important for such codes to include?*

A majority thought that codes of ethics should address issues of integrity, conflicts of interest, confidentiality and the use of an entity's assets and resources (including information).

Some respondents said it was appropriate to set out in codes the consequences of breaching them. Several considered that codes should include provisions relating to legal compliance, disclosure, good faith, transparency, trading in company securities, whistleblowing, responsibility to stakeholders, honesty in dealings with third parties, and the health and safety of employees and the wider community.

Some respondents stated that codes should include policies on the giving and receiving of gifts and political donations and others thought that codes should include a "no personal gain" policy. Several commented that, to be effective, codes should be kept simple and short. It was also suggested that each code's content be tailored to the particular company. Some respondents gave examples of codes on which a model could be based, including the Code of the Institute of Directors in New Zealand Inc and the NZX Corporate Governance Principles.

### *Q: What do you consider the most appropriate responses - both internal and external to the company - where such a code has been breached?*

There was strong support for having policies and procedures for dealing with breaches. Some people commented that these should be transparent and applied consistently.

*" One policy for all, and transparently so. ".*

The majority view was that the way breaches are handled, and the extent to which they are communicated externally and/or internally, should depend on the severity of the breach. Some respondents considered breaches should be dealt with internally, unless the law required external reporting and action. Suggested sanctions included fines, censure and dismissal.

Some people specified different responses for directors and employees. Some considered that codes should be enshrined in employees' contracts and breaches dealt with in the same way as breaches of any other company policy, with serious breaches resulting in dismissal. For directors, several respondents commented that failure to comply with codes should result in their resignation.

Some commented that breaches by senior management, directors and CEOs should be dealt with by the board, whereas breaches by staff can largely be dealt with by management. Several respondents thought that companies should decide the appropriate responses to breaches. Several considered that disclosure at some level may be appropriate.

The majority supported internal resolutions of breaches, but several respondents favoured the enforcement of codes of ethics by external bodies, such as NZX, the courts, or a regulatory agency. In the case of public sector bodies it was suggested that enforcement be handled by the Auditor-General.

### *Q: Do you have any other comments on this issue?*

The view of several who made further comments was reflected in one comment that:

> *"ethical conduct is the basis of governance – it sets the tone of an organisation and a behavioural standard against which to measure corporate actions".*

Some respondents commented that they already had codes of conduct or ethics. Some referred to the NZX Corporate Governance Principles and others to the Institute of Directors in New Zealand Inc's Code of Ethics, existing company law or professional body obligations as being sufficient.

Several respondents noted the importance of entities monitoring compliance with codes. Some commented that codes can provide stakeholders with a benchmark against which to measure an entity's performance. Some respondents were concerned about the risk of over-regulation and excessive compliance costs. Several commented on the difficulty of reaching consensus on what should be included in a code of ethics. Some concern was expressed that any agreed principles may be too general to be useful.

Several stated the view that it is not useful to attempt to codify ethics. It was also suggested that there is no need for ethical standards beyond those already imposed by law.

#### *Views by type of entity*

Views on ethical conduct appear to be based on personal or institutional philosophies. There was no apparent underlying trend by type of entity that suggested different entities, be they listed or unlisted companies, private or public sector, hold different positions on the issues surrounding ethical conduct, the need for codes of ethics or how to handle breaches.

## ISSUE TWO: Board Composition and Performance

**Key findings from respondents**

- An independent director has no relationship with the company that could compromise his or her ability to exercise unfettered judgment.
- An independent director should not be a substantial shareholder in, a material customer of, or a material supplier or professional adviser to, the company.
- Opinion was divided on whether independent directors should make up the majority of boards.
- Boards should have members who bring the skills and experience needed for the governance of the particular entity.
- Board size should be determined by factors including the size and complexity of the company and the skills and experience needed to govern it.
- The CEO should not be the chairperson nor go on to be the chairperson.
- Boards should review their performance yearly.
- Boards should review the performance of individual directors.
- More could be done to enable shareholders to assess board performance.
- Opinion was divided on whether directors should be certified or accredited.
- Entities should have recruitment and induction programmes for directors.

### Definition of independent director

***Q: Are the elements included in the following definition appropriate for the New Zealand environment?***

> *"Someone who is not an executive and who has no business or other relationship that could compromise – or could reasonably be seen to compromise – the ability to exercise their unfettered judgement. Such business or other relationships include being a substantial shareholder (or its representative), a material customer, supplier or professional adviser to the company."*

Responses indicated strong support for the elements in this definition of an independent director, particularly for larger and/or listed companies. Although the criteria were generally supported, some respondents questioned one or more of them. Several also suggested further criteria.

Some respondents argued that directors representing substantial shareholders should not necessarily be seen as contravening the definition of independence. Issues were raised about relationships with material customers or suppliers, with a number of people disagreeing with the notion that they could not be considered "independent". Some respondents queried the threshold at which a director with a perceived vested interest should be considered not independent.

In relation to professional advisers, some respondents noted that given the size of some professional partnerships, the definition may exclude people not actively involved in providing services to the entity in question.

Additional criteria that were suggested included the exclusion of:

- former executives or employees as persons unlikely to be considered independent (although some respondents suggested a "stand-down" period); and
- people who have personal or family relationships with people involved with the entity.

Some questioned whether long-term service on a board could jeopardise independence, although views on this point were mixed.

Generally contributors noted the limited pool of potential directors in New Zealand, and that this should be borne in mind when considering whether a person is sufficiently independent to serve on a board. On a related note, some contributors stressed that rules on independence should not be considered exhaustive, and should be interpreted in the context of the size and nature of each organisation.

Some stressed the importance of transparency of criteria for appointment, and of rules for dealing with possible conflicts of interest. Some suggested that disclosing directors' interests and board procedures for dealing with conflicts would address issues of independence.

Several suggested that definitions of independence should not distract attention from the responsibility of all directors, whether classed as independent or not, to act in the best interests of the company.

***Q: Should independent directors make up the majority of a board? In which situations might it be appropriate not to have a majority of independent directors?***

Opinion was divided on whether independent directors should make up the majority of a board. One respondent who supported a majority of independent directors said:

> *"This is best practice. The interface between board and management to be robust needs a majority of independent directors."*

Some of those who supported the concept suggested that while this might be appropriate for listed companies, it may not be appropriate for smaller, privately owned companies or larger or wholly owned subsidiaries. There were also comments on the representation of the interests of majority shareholders. It was suggested that some more specialised types of entities may not suit having a majority of independent directors, for example, co-operative companies have a majority of supplier shareholders.

Many who disagreed with the suggestion that independent directors should be a majority of the board, did agree that there is a need for some independent directors. Some respondents who disagreed with the suggestion cited the need for directors with relevant specialist or industry knowledge, and suggested that, where necessary, this was a more important criterion for board membership than independence.

Some respondents said that the question of independent directors was a matter for individual boards and their shareholders to consider, and that a blanket rule was inappropriate. Others noted that if interests are disclosed and directors act in accordance with established protocols relating to conflicts, the issue of their independence or otherwise should be irrelevant.

> *"Too great an insistence on independence may lead to organisations missing out on the best people for boards and at times it may be appropriate to recognise that the technical lack of independence of a director may not necessarily translate to an actual lack of independence."*

***Q: To what extent do you agree that the chair and CEO should not be the same person? What is your view on the suggestion that a CEO should not go on to become chair?***

There was strong support for the chairperson and CEO not being the same person.

*"This is fundamental. How can the same person provide an interface. The chairperson is the key person to monitor management. You cannot monitor yourself."*

Some respondents suggested that while this principle should generally be followed, there may be exceptions such as for the founder or majority shareholder of an entity.

The majority of respondents considered a CEO should not go on to become the chairperson. Some qualified their response by saying there might be cases where an exceptional CEO is the best choice for the position.

*"Generally agree, but should not be prescribed. Could be circumstances where, say due to specialist skills and attributes, this could be the best decision for the company."*

Some respondents with this view suggested that in these instances a stand-down period might be appropriate. An alternative suggestion was that a majority of independent directors might provide an appropriate balance in such circumstances.

Some of those who opposed the idea suggested that the potential disadvantages of a CEO going on to become chairperson included a reluctance for the new CEO to change decisions made by a predecessor who was now the chairperson.

***Q: Should a company's CEO automatically become a member of the board?***

Opinion was divided on whether a CEO should be *automatically* appointed to a board.

Of those who disagreed with automatic appointment most said that appointment may well be appropriate, but that individual companies should be left to make their own choices. Others who disagreed suggested that CEO board membership is inappropriate in any circumstances.

There was a strong view that board members need to be kept informed by management, but also need to be able to question management decisions. To this end many of those who favoured not automatically making the CEO a member of the board suggested that attendance by the CEO at board meetings should be required. Correspondingly, some of the respondents who agreed with automatic membership suggested that boards should meet from time to time without the CEO present.

***Q: What factors should be considered in determining board size, and is it feasible to define an optimum size?***

Opinion was divided on the optimum board size, or whether such an optimum size could be defined. A majority of respondents suggested that "function should dictate form" and that factors such as company size and complexity, and ensuring a good balance of desired skill sets, experience, qualifications, and industry knowledge should determine board size. Effectiveness was also seen as a key determinant of board size, as was shareholder structure. In this regard, some respondents suggested that boards should be large enough to provide a range of voices and opinions, but not so large that discussion cannot be effective. Where respondents did suggest an optimum size, numbers varied from 3 to 12 people, with between 5 and 9 being the most frequently proposed range.

***Q: The following questions were asked:***

- ***How regularly should boards review their own performance?***
- ***Should boards also review the performance of individual directors?***
- ***Are the current mechanisms which enable shareholders to assess board and director performance adequate? If not, how would you suggest these be improved?***

Opinion varied on how often boards should review their performance, and how this should be done. A great majority of respondents said boards should review their performance annually. Other suggestions included more frequent reviews (quarterly, for example) and longer intervals such as every two or three years.

The great majority agreed that boards should review the performance of their individual directors. Of those who disagreed, some questioned the value of this, suggesting that it would be difficult to implement or that a good chairperson should review the performance of individual directors on an ongoing basis. Some respondents were cautious on the subject of formal external reviews, suggesting that good board practice should provide for ongoing informal reviews, or that this was a matter for shareholders to determine.

Even where respondents supported the need for regular performance reviews, there was a strong view that the review process should not be mandatory.

Some respondents said the current mechanisms were generally acceptable for shareholders to hold boards to account. However, a majority of respondents proposed one or more additional measures to improve shareholders' ability to hold boards to account. Some said it was difficult for shareholders to assess board and management performance. A range of additional measures was suggested, generally focusing on a perceived need for greater transparency about board performance.

These included:

- better use of annual reports and other communications tools to highlight aspects of board performance;
- using external assessors to review performance;
- providing shareholder briefings by the board during the financial year, and forums for discussion between shareholders and directors;
- requiring issuers to report to shareholders against governance principles;
- using shareholder advocacy committees, reporting to the annual meeting; and
- providing records of directors' attendance at board meetings and time spent on board business.

Several respondents said that financial performance was the key gauge of a board's success. Others suggested that an increased emphasis on enforcing the remedies currently available in company legislation would be of assistance.

***Q: Should certification or accreditation of directors be encouraged?***

There were strong views both for and against the certification or accreditation of directors.

Some respondents supported certification or accreditation and considered that it could be useful, particularly for new directors. One commented:

> *"This is desirable especially for public companies, but would depend on the means and level of qualification ... it is important to refresh regularly on an ongoing basis..."*

However, respondents generally opposed any mandatory requirements for directors to be certified or accredited. Some suggested that such qualifications may have value as a mark of achievement or measure of competence, but should not be required as a formal qualification to become a director.

Some opposed the concept of certification or accreditation. For example:

> *"Disagree. Passing a test won't guarantee any improvement in corporate governance. Experience is what counts."*

Some suggested that an accreditation process would not necessarily provide the skills needed for effective board participation, and suggested that it may remove otherwise suitable people from consideration.

***Q: What processes should boards have in place to recruit suitable directors and to ensure they remain fit for their role?***

There was strong support for robust recruitment processes and general support for skill set requirements to be reviewed regularly.

> *"Rigorous analysis of the needs of the board for specific skills in the context of the business, and matching of recruitment process to identified skill requirements."*

Board appointment committees and the use of disciplined recruitment processes, similar to those used for executive recruitment, were also supported.

Some stressed the need for boards to focus on the necessary skills required in new directors, and to widen the pool of potential applicants. Induction programmes were strongly supported and there was some support for professional development programmes – although this was not seen as something that should be regulated. Of those respondents who were more sceptical about the merit of these programmes, several said that this should be dealt with as an informal matter or viewed as a responsibility for directors themselves, and not as a matter for the board.

***Q: Do you have any other comments on this issue?***

Several respondents were strongly of the view that increasing shareholder value is the key responsibility of a board of directors and that this should be the main consideration when appointing directors and assessing their performance.

Others suggested that boards should seek to achieve the right balance of skills and experience. Personal qualities such as integrity and diligence were considered important. Diversity was also seen as important, but not at the expense of skills.

Several respondents said that a key factor in board performance is the "team relationship" or "chemistry" between members, together with strong leadership by the chairperson. Some cautioned that intangible factors such as these can be destroyed by too many prescriptive rules about board composition and procedures.

Some respondents noted that independence from management is very important. It was suggested that non-executive directors meet regularly without management, and that boards regularly review their delegations to management.

There were some comments about the appointment and retirement of directors, including a need for contested elections and/or regular re-elections, a set retirement age or fixed maximum term, and a limit on the number of directorships that may be held at one time.

Some respondents commented on the nature and amount of director remuneration, although opinion was divided on whether remuneration should generally be higher or lower than current remuneration levels, or whether share or option schemes encourage performance.

*Views by type of entity*

Those who replied on behalf of unlisted companies were more likely than those from other entities to maintain that there were difficulties in including "substantial shareholders" in the definition of independent director. Similarly, those replying on behalf of unlisted companies tended to argue that the limited pool of director talent available in New Zealand should be taken into account.

Of those respondents who emphasised the need for transparency in personal/supplier relationships, those responding on behalf of professional associations were more likely than others to advocate a high level of transparency.

Representatives of listed companies, professional firms and associations were more likely than those of other entities to support the majority of directors being independent directors.

Those people identifying themselves as board chairs were more likely than others to support the need to review the performance of individual directors.

On assessing the performance of boards as a whole, people from professional firms were more likely than others to suggest that current mechanisms were inadequate.

Relatively few respondents from unlisted or listed companies supported the certification or accreditation of directors. The strongest support for this came from associations and professional firms.

## Issue Three: Board Committees

**Key findings from respondents**

- Board committees set up for specific purposes can improve effectiveness, however boards should retain responsibility for policy and governance.
- Public companies should have audit committees to appoint and oversee external auditors.
- Audit committees should have an independent chairperson and a majority of independent directors.
- Audit committees should have at least one member with financial expertise.
- Large boards should have a remuneration committee.
- Opinion was divided on the need for appointment committees.
- Remuneration and appointment committees should have a majority of independent directors.
- A person should be able to sit on both the remuneration committee and the audit committee.

### *Q: What are the benefits and/or drawbacks of board committees in the New Zealand environment?*

The majority of respondents saw the benefits of board committees outweighing the drawbacks.

Respondents noted that benefits of committees include:

- bringing a focus and appropriate expertise to the consideration of board issues;
- enhancing board efficiency and effectiveness;
- enabling issues to be studied in-depth;
- allowing for a better division of workload;
- allowing for specialisation; and
- giving board members specific areas of responsibility.

Committees were viewed as more beneficial for larger or listed companies and companies with large boards. Several respondents considered that audit and remuneration committees have a particular place. Some noted that committees are beneficial for improving governance.

> *"Sub-committees do have a role in large organisations. They are also useful in the monitoring of specific projects. They should not be used to denigrate the Board's collective responsibility or to isolate some members from the decision making process."*

Drawbacks were seen in delegating responsibility to committees when whole boards should be responsible and accountable. Some respondents thought that full reporting by committees to boards was also desirable, with confirmation of committee decisions retained at board level. Some said that certain matters should not be referred to committees. Others considered that committees should only have delegated powers of recommendation back to full boards. Some noted as drawbacks the practicalities of having committees when board size is limited, and the small size of most (New Zealand) organisations. Several noted that committees are not necessary for smaller boards.

Some supported committees being optional and kept to a minimum. Several said that a committee should only be established where it improves the board's effectiveness. Some were concerned that directors may not have a complete understanding of issues if there are too many committees. Others considered it important that committees not duplicate the work of boards. Some respondents emphasised the need for committees to have clear and transparent terms of reference, powers and membership.

***Q: Is it appropriate in the New Zealand environment for public companies to establish board audit committees with formal responsibilities for appointing and overseeing external auditors?***

There was close to unanimous support for audit committees with responsibilities for appointing and overseeing external auditors.

Qualified support was based on the size and legal status of the entity (with the strongest support being for listed companies having audit committees). Some respondents noted that it would be appropriate for larger companies and for companies with wide public ownership. Others agreed that it was appropriate, but noted that for smaller boards the appointment and oversight of external auditors could be done by the board as a whole. The view was expressed that an audit committee should not be mandatory and is a matter for the board to decide.

Several respondents did not consider board audit committees to be appropriate in a New Zealand context. Some noted that boards as a whole could perform this function.

***Q: Is it appropriate in the New Zealand context for audit committees to include a majority of independent directors and an independent chairperson?***

There was strong support for requiring audit committees to include a majority of independent directors and an independent chair. One respondent said:

> *"In New Zealand an audit committee should comprise wholly or substantially independent non-executive directors. The chair of the committee should be an independent non-executive director. Except in the case of companies having a small number of directors where it can give rise to practical difficulties, the chair of the board should not also be chair of the audit committee."*

Several respondents who gave qualified support suggested that the chair of the audit committee should not be the chair of the board, and that the committee need not comprise a majority of independent directors. Several considered that a majority of independent directors would be desirable but that an independent chair may not be necessary. Some respondents said it was important that the audit committee be made up only of independent directors and an independent chair. Others supported the practice but considered it should not be mandatory.

A minority disagreed with the requirement for a majority of independent directors and an independent chair. Of these, some considered it should not be mandatory and that it was the board's decision. Some considered that the board members with the most appropriate skills should be used, although obvious conflicts should be avoided. Others suggested, in relation to listed companies, that it should not be a requirement but that the basis of a decision to vary from majority independence should be communicated to shareholders.

Some respondents (both those who agreed and who disagreed with the need for independence) commented on the definition of "independent director". Some noted in relation to supplier directors of co-operative companies that although directors may be impartial, they are not likely to be "independent" because they may trade with the co-operatives. A distinction was drawn by some respondents between "independent directors" and "non-executive directors", with the view that audit committees should not include executive directors.

***Q: It is often a requirement for audit committees to have at least one member with financial expertise. What other capabilities or credentials ought to be reflected within the membership of an audit committee?***

There was strong support for audit committees having at least one member with financial expertise.

Other skills seen as important included legal knowledge, risk management expertise, industry knowledge, experience, "a questioning mind", independence, integrity, knowledge of the company, knowledge of operational and strategic risks, and an understanding of the audit process. Good judgment and commonsense were seen by some respondents as important attributes.

Some respondents considered a formal accounting qualification necessary. Others noted the need to have sufficient time to devote to the role. A small number said that the attributes that made someone eligible to be a director should be sufficient to qualify them for sitting on an audit committee.

***Q: Is it appropriate in New Zealand for boards above a certain size to delegate responsibility for director and executive remuneration to a board remuneration committee?***

There was strong support for the proposition that boards above a certain size have a remuneration committee. Some respondents said this was a matter that should be left to boards to decide.

> *"Director and executive remuneration will always be of interest to shareholders. .... Establishing a remuneration committee that has a formal and disclosed charter clearly indicates that a company has a methodical way to set ... remuneration. Companies with large boards may be more efficient if they delegate setting these policies to a remuneration committee however ... such decisions are fundamentally the role of the board."*

Of those who gave qualified support for the proposition, many said that the matter could be delegated to committees to consider and make recommendations, but it was for boards to make determinations on remuneration. Some said it should not be mandatory. Others noted that it would depend on the type of entity, the size and legal status of the company, the complexity of the company and the size of the board. Generally it was seen as more appropriate for larger or listed companies and companies with larger boards.

Some who disagreed did not consider it necessary given the size of most New Zealand companies. Some respondents considered that shareholder input to the process is important. Others said it was not relevant to district health boards and not appropriate for local government.

With or without a dedicated committee, a clear and transparent remuneration policy was seen as important.

***Q: Is the establishment of appointment committees with delegated responsibility for recruitment and the appointment of new directors and executives appropriate in New Zealand?***

Opinion was divided on the need to establish appointment committees.

Company size and board size were seen as determinants of the need for an appointment committee. Generally it was seen as more appropriate for larger companies and companies with larger boards. Some respondents considered that the decision on whether to have an appointment and nomination committee should be optional and at the discretion of the board. Some thought that an appointment committee might be established on an ad-hoc basis rather than as a standing committee.

Several respondents who provided qualified support suggested that, while it may be appropriate to have an appointment committee, it should not have delegated responsibility for making appointment decisions. Some thought the role of the appointment committee should be to consider and make recommendations to the board, with the board to make any determination and accept responsibility for the decision.

> *"Appointment committees are appropriate, and suitable for making recommendations, however the full board should retain final responsibility."*

Some respondents who disagreed considered it to be a matter for the full board, or considered it unnecessary or inappropriate. Some queried whether there was any merit in establishing such committees and noted the small size of the New Zealand market.

Informed decision making and a transparent process were seen as important, whether or not an appointment committee was used.

The question was not seen as relevant for appointments to district health boards and public sector entities. For some roles, appointments were made externally and based on different criteria.

***Q: Should independent directors make up the majority on remuneration and appointment committees?***

Although opinion was divided on the need for boards as a whole to include a majority of independent directors, there was strong support for remuneration and appointment committees to be made up of a majority of independent directors.

> *"Yes, this would encourage independence and objectivity in these sensitive areas."*

Where agreement was qualified, respondents noted the size of the company, the size of the board and whether it would be feasible to achieve this. Some said it was more important that the majority were non-executive directors, and others qualified their support according to the definition of "independence" used.

Some respondents disagreed. Several said that the people with the best skills should be used. Others disagreed because it would be too restrictive for some organisations. Some noted that "independence" does not enable directors to better fulfil the functions of the committee. Others considered it was a matter for the full board to decide.

Some respondents considered these committees should comprise only independent directors.

***Q: Do you agree or disagree with the view that audit and remuneration committees should comprise different people (ie that no director should sit on both)?***

A majority of respondents disagreed that audit and remuneration committees should be composed of different people. A typical comment was:

> *"Disagree. The committees should comprise the best skills from around the board table. Obvious conflicts should be avoided."*

Some considered that the best person for the job should be appointed. Others commented that board size might constrain this and that it may not be feasible or practical in a New Zealand context. Some respondents did not see any particular conflict with a director sitting on both committees, and several said that a person should not be disqualified from sitting on another committee. However, some people thought there should be a material difference in committee composition, and others supported having an independent chairperson.

A small number noted that factors such as board size, experience, expertise and the need to spread the composition and workload of committees should be considered.

*Q: Do you have any other comments on this issue?*

There was a strong view that although committees may be useful for dealing with matters in detail, full boards must retain responsibility, particularly for policy and governance decisions. It was suggested that committees should report to boards, that minutes of committee meetings be circulated to boards, and that committees should not be able to decide policy or commit boards on major decisions.

Some people said that committees should be used as appropriate to the particular organisation and should not be mandatory. Others thought that committee terms of reference, composition and procedures should be clearly defined and regularly reviewed by the board. Some noted the need to avoid conflicts of interest when appointing committee members, and queried whether the chairperson of a board should chair any board committees.

Specific comments about audit committees included that

- audit committees should be independent of management and should receive the reports of both internal and external auditors; and
- audit committees should report directly to shareholders.

A few respondents suggested that committees should be able to use external advisers. It was also suggested they should be able to co-opt members who were not directors.

*Views by type of entity*

While a number of issues were raised in relation to the role and composition of board committees, no discernable trends or themes emerged when analysed by type of entity.

## Issue Four: Reporting and Disclosure

**Key findings from respondents**

- Companies should report on their performance against governance principles.
- No obvious gaps were identified in the current disclosure requirements for listed companies.
- Unlisted companies with public shareholders should improve disclosure.
- Opinion was divided on the need for other unlisted companies to disclose more information than they do now.
- Listed companies should not be required to report quarterly.
- CEOs and CFOs should publicly sign off financial statements.
- Auditors, audit committees, and the enforcement of reporting requirements are important safeguards.
- Reports should be easy to understand.

***Q: Continuous disclosure has been a requirement for publicly listed companies in New Zealand since December 2002. In relation to good corporate governance, are there any areas or matters on which additional disclosure should be encouraged?***

A majority of respondents said there were no other areas or matters in which they considered additional disclosure should be encouraged. Some of these people added comments including

- New Zealand's continuous disclosure regime is sufficient in relation to disclosure of company information;
- this was a matter for shareholders to determine via boards; and
- existing statutory requirements provide adequate protection of rights.

Some respondents said commercial sensitivity is an issue and it would be difficult to prescribe what is appropriate for the public arena.

A minority of respondents suggested that a greater level of disclosure in relation to the principles of good governance be encouraged. These people sought more disclosure of the matters covered in the questionnaire, including:

- related party dealings;
- codes of ethics;
- share trading by directors and executives;
- remuneration;
- minutes of shareholder meetings;
- NZX compliance;
- board composition and performance; and
- risk management processes.

Other comments were that it is too early to tell whether the continuous disclosure regime is "sufficient", and that good corporate governance is poorly defined and too easy to manipulate.

***Q: Do you believe there is a need for greater emphasis on timely, accurate and complete disclosure by unlisted companies?***

Opinion was divided on the need for unlisted companies to adopt a higher level of disclosure.

Among those who supported greater disclosure, there was a view that the level of public interest in the unlisted entity should determine whether a higher lever of disclosure was needed.

> *"... the benefits of information disclosure go beyond the maintenance of an informed securities market, and there would be benefits for stakeholders .... of unlisted companies in enhanced disclosure. ... Continuous disclosure is also important for unlisted entities with an element of wide or public ownership however.... it is appropriate that entities be able to adopt and justify different positions."*

There was support for a greater emphasis on timely, accurate and complete disclosure in unlisted companies that are widely held, and when there is public money at stake.

Of those respondents who did not consider that a higher level of disclosure is required, a number suggested it was important that the public understands the risks involved in investing in the unlisted market. Others said the requirements of the Companies Act 1993 were sufficient.

***Q: Do you believe that listed companies in New Zealand should report quarterly?***

A majority of respondents disagreed with the proposition that listed companies should be required to report on a quarterly basis. Of those who disagreed, many said that continuous disclosure is sufficient. Others noted compliance costs, and the risk that quarterly reporting would encourage entities to focus on managing short-term results.

Some respondents who supported quarterly reporting said that listed companies should be able to meet the extra costs involved, and that as companies prepare monthly accounts there should be no problem generating quarterly results. One representative of a large international entity said that quarterly reporting encouraged the highest standards of investor disclosure. Some welcomed the idea of quarterly reporting, but said it should be voluntary and not mandated.

***Q: Do you think it is appropriate in New Zealand for CEOs and CFOs to publicly certify the accuracy and completeness of financial statements?***

A great majority supported the proposition that company CEOs and CFOs should publicly certify the accuracy and completeness of financial statements. Several respondents went as far as saying this should be a fundamental requirement.

> *"Absolutely essential for proper accountability, it would put the emphasis where it should sit, that is, where the detailed knowledge resides."*

Other comments included that CEO and CFO certification is essential to proper accountability, and that there should be a penalty for those making an untrue certification. A small number said that certifying the accuracy and completeness of accounts to boards should be required but that it was not necessary to extend this to public certification.

Of those who did not support the proposition, some argued that it is the auditor's responsibility. Others said that directors should remain primarily responsible to the public because the CFO and CEO are employees and should only certify the accuracy and completeness of financial statements to the board if the board required it. For example:

> *"Not necessary. The board reports and should be getting its certificates – part of internal procedure."*

*Q: What other safeguards are needed for ensuring integrity in reporting practices and outcomes?*

A majority of respondents suggested that additional safeguards would be useful. Most comments focused on strengthening audit committees and independent auditors. Some suggested that stronger enforcement and penalties are required.

Some respondents commented on boards being equipped with financial knowledge, certification of financial statements by directors, and good quality financial reporting. Comments also included the importance of robust whistleblower policies.

*Q: Should companies report on their performance against the accepted principles of good corporate governance or explain why they haven't?*

There was strong support for the proposition that companies should report on their performance against accepted principles of good governance.

Some said this should not be overly prescriptive. Some respondents qualified their support by saying that reporting should be kept simple, and others said that a balance needs to be struck between hard rules and best practice.

There was strong support for "if not, why not" reporting for listed companies. For unlisted companies some respondents thought this was a matter for boards. Some suggested a template might be useful (particularly for smaller companies), but others warned against the ease with which people can conform to a check list. There was a strong view that reporting should not become a "tick-in-the-box" exercise. Some suggested that reporting should involve describing compliance as much as non-compliance.

Of those who disagreed, many said this would be a waste of time and would not add to shareholder value. Others said it is difficult to report on the "performance" of principles. A few said it depended on what the principles were.

*Q: Do you have any other comments on this issue?*

The most significant other issue identified was the need for company reporting to be easily understandable to shareholders. The roles of analysts and the financial media in this were questioned and it was commented that more investor education could help. Suggestions were made about enforcement, including protection for whistleblowers. The comment was made that regulating disclosure will not help overcome fraudulent behaviour.

*Views by type of entity*

Representatives of associations and professional firms tended to have more to suggest in relation to additional areas for disclosure.

The majority of company representatives said current requirements were sufficient.

On the issue of whether there should be a greater level of financial disclosure from unlisted companies, support was spread across all entity representatives, including those from unlisted companies.

People from professional firms were less likely to support the CEO and CFO certifying the accuracy of financial reports.

## ISSUE FIVE: Remuneration

**Key findings from respondents**

- Opinion was divided over whether all directors' remuneration should be linked to company performance.
- Linking remuneration to company performance risks directors taking a short-term rather than a strategic view.
- Fees paid to non-executive directors may be too low to attract and retain the right people.
- Opinion was divided over whether a portion of non-executive directors' remuneration should be in shares or options and whether they should be paid retirement benefits.
- CEO and senior management remuneration should be disclosed.
- Executive remuneration should not be subject to shareholder approval.

***Q: Internationally, there is a trend to explicitly link directors' remuneration with company performance. To what extent do you think this should be the case in New Zealand?***

Opinion was divided on whether directors' remuneration should be linked to company performance. A respondent who supported this link commented:

> *"Directors should be prepared to back their judgement by having "skin in the game."*

Some people said it should apply to managing and executive directors. There was no consensus on whether it should apply to other directors. Some said that it should definitely not apply to independent directors.

Some who supported linking remuneration to company performance pointed to risks of creating incentives for taking a short-term rather than a strategic or longer-term view of the company. Other supporters thought remuneration should be linked to the objectives in the annual plan and that this would provide an alignment of directors' incentives and shareholder value. There was a suggestion that any proposal to increase directors' fees be justified by evidence of good performance.

The respondents who disagreed with explicitly linking company performance to director remuneration also emphasised the risk of encouraging short-term thinking rather then long-term planning. It was suggested that a link between remuneration and company performance could undermine ethical conduct.

> *"Directors are employed and remunerated by the shareholders for the long term based upon a stewardship and fiduciary role and there should be no link between short-term remuneration and company performance. It would be difficult to define performance for these purposes. Performance based upon sharemarket outcomes could lead to short-term decision making."*

It was noted that local authorities, such as district health boards, have their directors' remuneration determined by a legislative process.

***Q: Do you agree that, in New Zealand, non-executive directors' remuneration is currently set at a level to attract and retain individuals who will make a significant contribution to company performance?***

There was a strong view that non-executive directors' remuneration is not currently set at a level that will attract and retain people who can make a significant contribution to company performance.

Some people supported this by saying remuneration was too low for the responsibilities, expectations and risks associated with being a director.

> *"... given the responsibilities and expectations [fees] are generally too low."*

Others said that while it might be acceptable currently, it is generally inadequate to attract the necessary talent for the future. It was noted that some larger public companies are starting to address this issue.

***Q: Do you believe there are any circumstances in which it is appropriate for non-executive directors to receive retirement payments?***

Opinion was divided over whether there are circumstances in which it might be appropriate for non-executive directors to receive retirement payments. A strong view was this should never occur, but a significant minority supported it. Several said that directors should be paid a total remuneration package throughout their tenure, therefore avoiding the need for retirement payments.

> *"Depends on the adequacy of the fees. May be justified in some cases. Preferable that annual remuneration is appropriate to avoid this."*

Some thought retirement payments were appropriate only where directors' fees were low, and where payment was linked to company performance over the directors' tenure. It was suggested that any payments be assessed on a case-by-case basis and in all circumstances paid only if approved by shareholders.

***Q: Do you agree with the view that at least part of a non-executive director's remuneration be 'at risk' on the basis of company performance?***

Opinion was divided on this.

Of those who disagreed some said that directors should be paid a fair fee as paid professionals and others raised the issue of needing to avoid creating incentives for short-term decision making. There was also a view that directors' appointments themselves should be at risk based on non-performance. Some said it was important that all directors be treated equally in relation to pay-for-performance incentives.

One comment was:

> *"Long term there may be some merit, but if it is short term based then no.... as it may lead to decisions being made that are contrary to the company's and its shareholders' longer term interests."*

Of those who supported the idea of part of a non-executive director's remuneration being at risk, some qualified this by saying it should only occur within the total remuneration level approved by shareholders. Others said that while some kind of performance-related remuneration is important, it is also important to be clear about what the performance indicators are.

***Q: Is it appropriate for a proportion of a director's remuneration to be paid in company shares or in options in the company's shares? If so, should this be expensed against company earnings.***

Opinion was divided.

Several people answered "no" to the first question but some of these qualified their opinion by supporting payment in shares but not options, and others opposed such remuneration for non-executive and independent directors. Concerns were raised around compromising judgment, options diluting existing share holdings, and the possibility of abuse. A few said payment in shares creates a conflict that the governance debate is aimed at eliminating.

Where people supported some payment in shares, there was strong support for this to be fully disclosed and approved by shareholders. If directors are paid in company shares or options, there was close to unanimous support for these being expensed against company earnings.

The fact that the treatment of such payments is an unresolved issue in accounting circles was raised.

***Q: Some commentators warn that linking executive and directors' remuneration to company performance over one or two years can create a "short term" bias in thinking. To what extent do you think this is an issue in New Zealand today?***

A great majority of people saw "short-termism" as an issue when executives' and directors' remuneration is linked to company performance with several saying this was a "real issue" or a "real problem" in New Zealand today.

> *"I am convinced that this is an issue, particularly in our large public companies."*

Others said "short-termism" was a particular problem unless these was a balanced linkage to short-term and long-term strategic performance. The point was made that boards should be able to identify this problem and rectify it.

Of those who disagreed that this was an issue in New Zealand today, some noted it was an issue more with executives than directors. Others noted that the problem was less one of short-term bias than one of poor performance overall and the "inverse relationship" between remuneration and company performance.

***Q: To what extent do you agree that the remuneration terms of a CEO's contract and those of senior management, including termination payments should, be disclosed to shareholders?***

A majority of respondents agreed that the remuneration terms of a CEO's contract and those of senior management, including any termination clauses, should be disclosed to shareholders. Those offering qualified support suggested reporting in bands or without reference to particular individuals. Others said that transparency of policies was a core issue and more important than disclosure of actual amounts. Some suggested that disclosure of remuneration terms should apply to CEOs but not necessarily to all senior managers.

Where people disagreed, their comments included that present levels of disclosure are sufficient, that personal contracts should be kept private, and that shareholders appoint boards to manage this process.

***Q: There is a view that executive remuneration should be directly subject to shareholder approval. Under what circumstances would you consider this appropriate in New Zealand?***

The great majority of respondents disagreed with the view that executive remuneration should be directly subject to shareholder approval.

There was a strong view that this is a matter for the board. Some said there was no need, so long as there is transparency around what is being earned. It was noted that directors are better qualified to assess appropriate remuneration structures than shareholders.

Of those people who agreed that there might be some circumstances in which it is appropriate for shareholders to approve executive remuneration, the issue of an executive also being a director and/or a shareholder was raised. It was suggested that this might be relevant in non-performing companies, and also that shareholders should be told of material changes in remuneration policies or levels.

***Q: Do you have any other comments on this issue?***

Other points noted in relation to remuneration were

- the need to avoid shifting management decisions to shareholders;
- some shareholders could have equally short-term objectives, which could diminish the value of disclosure;
- significant shareholding by an independent director could diminish independence;
- directors and employers must act in the best interests of the company, so ideally at-risk payments should not be required; and
- remuneration should be linked to long-term company objectives.

Several people commented that fees for executive directors are too low. It was suggested that comparisons be made with other professionals who assume a similar degree of responsibility.

***Views by type of entity***

Representatives of listed companies, professional firms and associations were among those offering the strongest support for linking remuneration to performance.

People from listed and unlisted companies were most likely to identify circumstances in which it might be appropriate for non-executive directors to receive retirement payments.

In response to the suggestion that at least part of a non-executive director's remuneration should be "at risk" on the basis of company performance, people from professional firms and listed companies were most likely to offer a blanket "no".

## ISSUE SIX: Risk Management

**Key findings from respondents**

- Entities should have risk management policies.
- Financial, market, operational, and environmental risks, delegations, and succession planning should be included in risk management policies.
- Opinion was divided on whether risk management policies should be published.
- Risk management policies and procedures should be monitored and regularly reviewed.
- Focus on risk should not stifle business.

***Q: To what extent do you believe New Zealand boards are adequately addressing the identification and management of risk?***

There was a wide range of views on the extent to which New Zealand boards are adequately addressing risk management as part of their governance processes.

Some said that it is (and should be) an area of increasing focus for boards and that risk management was improving. There was a strong view that standards are variable. As one respondent noted:

> *"Some are doing well, but many are not."*

Some people suggested that while some of the largest listed companies have enterprise-wide risk management frameworks, this practice is far less frequent in smaller listed companies and almost non-existent for non-listed companies. Others suggested that the view of risk and risk management may be too narrow if the focus is confined to financial loss and legal compliance.

Some respondents cautioned against adopting a "tick-in-the-box" approach to risk management saying business is by its nature risky and it may not be appropriate to legislate for many types of risks that commercial ventures were likely to face. Some said successful companies would already be managing risk well.

***Q: What should risk management policies and procedures to encompass (e.g. financial, market, operational, and environmental risk, delegation of authorities and succession planning)? Do you believe risk management polices and procedures should be published?***

The majority of respondents agreed that financial, market, operational, environmental risk, delegation of authorities and succession planning should be included in risk management policies and procedures. Other suggestions included legal compliance, technology and intellectual property, health and safety, delegations and roles, and supplier relationships.

Some respondents thought that risk management policies and processes should be linked to business goals and/or value drivers within a company, and that these policies need to be specific to the business of a company. There was strong support for having risk management policies. However, some respondents said that while the main risks to any company should be identified and assessed and the right management responses put in place, this was not something that should be regulated or prescribed.

Opinion was divided on the need to publish risk management policies.

Some favoured publishing policies or a summary of policies. Some commented that this would improve board focus and accountability. Others noted that these sorts of policies are commercially

sensitive and in many instances a source of competitive advantage. Others said that they should be published internally, not externally, and it was suggested that only the critical outcomes for which directors are held responsible be published.

> *One comment was: "[Risk management policies and procedures] should be published only to the extent that it does not compromise the [entity's] competitive position."*

***Q: Do you have any other comments on this issue?***

The issue raised most frequently was that any risk management policy must be subject to appropriate oversight and review of its implementation. Suggestions for this included monitoring by a board committee, by external or internal auditors, or by senior management.

Several noted that risk management policies must be tailored to the size, structure, and business of an entity. Similarly, risk management was considered important for public bodies, although policies must be appropriate for those bodies.

Some said risk management should be seen as a positive contributor to maximising opportunities for companies, but others warned that too great an emphasis on risk could stifle businesses. There was a strong view that risk management should not be a mechanical "tick-in-the-box" exercise.

***Views by type of entity***

Representatives of professional firms were more likely than others to suggest there is room for improvement in the way in which New Zealand businesses deal with risk management.

## ISSUE SEVEN: Auditors

**Key findings from respondents**

- The role of auditors is important to good corporate governance.
- Rotation of audit firms should not be required.
- Audit partners should be rotated, preferably every five years.
- Auditors should not do work that could compromise their ability to produce independent audit reports.
- Disclosure of fees paid to audit firms should identify specific types of non-audit work.
- Non-audit work should not be capped to a specific proportion of all fees paid to an audit firm.
- Boards should have whistleblower policies and disclose them.
- An independent audit oversight body is not required.

***Q: To what extent should rotation of audit firms be considered appropriate in New Zealand?***

A majority of respondents said that the rotation of audit firms is neither necessary nor appropriate, but some said that firm rotation should be a requirement.

Those opposed to audit firm rotation argued that in the New Zealand context the small pool of qualified audit firms would make this impractical.

> *"We believe the New Zealand market is too small with too few large chartered accountancy firms capable of undertaking large assignments, to mandate rotation of audit firms."*

Some said that audit firm rotation might give less assurance to directors and shareholders because of the time it takes to become familiar with the work.

Other respondents emphasised the significant additional expense and time associated with a lack of familiarity resulting from firm rotation. Some noted that firm rotation was anti-competitive, as audit firms may get work other than as a result of good audit skill, and this may lead to a spread of clients across the few large firms with no price competition at all.

It was also noted that subsidiaries of overseas companies may need to follow the requirements of the overseas parents.

Several people who supported audit firm rotation suggested it was appropriate only for larger or listed companies. Most of the respondents who supported the rotation of audit firms said this should occur every 3 to 5 years.

***Q: To what extent should there be a rotation of audit partners in New Zealand? If this is appropriate how often should audit partners be rotated?***

The great majority agreed that audit partners should be rotated. The limited size of the New Zealand market was stressed, and some respondents cautioned against making partner rotation compulsory.

> *"Audit partner rotation is generally seen as an element in maintaining both the fact and appearance of auditor independence. ... such a situation is desirable ... auditor partner rotation was expected to contribute positively to corporate governance."*

A small number of people said this was unnecessary. Some instead favoured firm rotation, questioning whether partners in the same firm are likely to challenge each other.

Opinion was divided on how often audit partners should be rotated. Views ranged from 3 to 10 years, with strong support for once every 5 years. Others said it should be at the discretion of the audit committee.

It was noted that rotating both the lead and review partners should be considered, with the rotations being staggered to effect continuity within the audit team. It was also suggested that lead and review partners then have no involvement with the client for a specified period.

***Q: What types of non-audit work should be of concern in the New Zealand context (e.g. valuation services, executive recruitment)?***

Opinion was divided on the extent to which audit firms should provide non-audit services to client companies.

The strong view was that audit firms should not undertake any work that could influence (or be seen to influence) their ability to produce impartial and independent audit reports.

> *"Audit firms should not undertake any work that could have a future impact on their independence as regards the audit .... "*

Some suggested that all non-audit work should go to another company. Other respondents noted specific tasks, including valuation services, tax advice, strategic planning, risk management and business planning that should be excluded where an audit relationship exists. Major transaction work, investment advice, executive recruitment, and IT services were also mentioned.

A small number said that the issue was not the type of work, but the non-audit work fees in relation to audit fees. If the audit fee is only a small part of an accounting firm's overall fees from a company, the integrity of the audit work may be questioned.

Several referred to the rules of the Institute of Chartered Accountants in New Zealand and the International Federation of Chartered Accountants and said these were sufficient guides and there was no need to replicate them.

***Q: Do you think disclosure of fees paid to audit firms should differentiate between types of non-audited work?***

There was close to unanimous support for the disclosure of fees paid to audit firms to differentiate between types of non-audit work.

***Q: Do you think the total of non-audit work should be limited to some proportion of all fees paid to audit firms each year and, if so, what proportion?***

The majority said that restricting the amount of non-audit work to some proportion of all fees paid to an audit firm each year would have an arbitrary effect.

> *"... the board or governing body of an organisation and its auditor are responsible for ensuring that audit independence is not compromised. Mandating maximum levels of remuneration or non-audit work will not assist that process."*

There was a view that certain types of non-audit work were not appropriate, regardless of proportion. Other respondents emphasised adequate audit committee monitoring and disclosure of fees as more important concerns, with strict proportions being overly prescriptive and difficult to implement.

Some said that a cap on fees for non-audit work should be established, but others said this should be set by boards of directors rather than being mandated, and that it should be published as part of a corporate governance section in annual reports.

Of those who suggested set caps, some said that the total allowable level of non-audit work should be 5% to 10%. Others preferred 25% to 30%, and a few 50%.

***Q: Should boards and/or board audit committees develop and disclose policies for handling complaints by auditors or internal whistleblowers?***

The great majority agreed unconditionally with this.

Several thought that these policies should be developed but that complaints were matters for management that should be disclosed only within the company.

It was stated that there was a need for an external channel owing to the number of cases where an employee whistleblower would be dealing with the cause of the whistleblowing.

***Q: Should an independent audit oversight body be required in New Zealand?***

The great majority did not think an audit oversight body is required in New Zealand.

> *"We do not believe there are the widespread problems that would justify the establishment of such bodies. In our view, current statutory requirements work satisfactorily and are adequate."*

A small number supported an independent audit oversight body. Some gave qualified support, but commented on the potential cost. Others would support an oversight body that was properly constituted and independent. The comment was made that the terms of reference would be important, and whether the body would be auditing the auditors or setting audit standards. There was also a concern that there may be an insufficient pool of talent for the initiative as "it is all currently sitting with the auditing profession". In support, some said that it might give some comfort to overseas investors who have similar bodies in their own jurisdictions.

***Q: Do you have any other comments on this issue?***

The majority of comments reflected a view that the role of auditors is an important part of corporate governance.

A small number said that there is too much attention paid to auditors, that the audit process is (or has become) a waste of time, and that it is better to improve the reporting practices of companies than to focus on audit practice.

It was noted that appropriate sanctions for wrongdoers would be a more effective response than restrictions placed on everyone. Along with enforcement, it was noted that monitoring audit practice (including by boards) was very important.

The role of the audit committee was stressed by some, both in monitoring the audit and in providing an avenue for communication with external and internal auditors.

It was suggested that the reasons for the resignation or dismissal of an auditor should be disclosed. Some company representatives noted that they have formal audit charters that are disclosed. Some respondents noted that while independence is important, the auditor's role should not be entirely that of detecting wrongdoing. The auditor should also be used as a source of constructive advice on best practice.

A few respondents said that auditors and audit practices have been unfairly targeted as a result of a few overseas failures, and that generally New Zealand practice has been of a high standard.

Others noted that the Companies Act 1993 requires that auditors be appointed at the annual meeting of a company, and that shareholders have a responsibility to question the independence and performance of auditors. However, it was also said that in practice this has had limited effect, and that most auditor appointments simply follow board recommendations, with auditors often retiring and being appointed (by the board) between annual meetings.

***Views by type of entity***

The strongest views opposing audit firm rotation came from representatives of professional firms and listed companies.

Those from professional firms were less likely to support the need for an audit oversight body than others. Otherwise, there were no discernable trends.

## ISSUE EIGHT: Shareholder Relations

**Key findings from respondents**

- Companies could improve dialogue with their shareholders.
- Companies should facilitate appropriate access by shareholders to auditors.
- Opinion was divided on whether institutional shareholders should always vote on shareholder resolutions.
- Opinion was divided on whether listed companies should publish a formal shareholder relations policy.
- Listed companies are reasonably good at providing shareholders with comprehensive and easily understood financial information.
- Other entities should provide more comprehensive public reporting.

***Q: How well do New Zealand companies encourage meaningful dialogue between the board, management and shareholders?***

Some said that this was done "generally quite well" or "reasonably well". However it was a strong view that this was "poor" or "not well done", and that there was room for improvement in shareholder communications.

> *" ... companies nowadays generally acknowledge the importance of meaningful dialogue between the board, management and shareholders, and are increasingly encouraging it ... there is nevertheless always room for improvement in this area."*

Some commented that under the continuous disclosure regime shareholders are now provided with more information than in the past. Some said that large and small shareholders still receive different treatment. Others said that too often communication is about past performance and there is limited opportunity for shareholders to express views on the future direction of a company.

Some raised concerns about the cost of communication and others questioned the extent to which all shareholders want more communication. Several questioned the effectiveness of annual meetings, and some said that communication was limited to the obligatory reports and the annual meeting.

***Q: Should companies facilitate shareholder access to auditors?***

There was strong support for facilitating shareholder access to auditors, but a majority of respondents would restrict this to specific occasions such as the annual meeting. It was noted that it is important to bear in mind the materiality and relevance of any issue to be raised with the auditor by the shareholder.

There was a strong view that shareholder concerns about audit matters may already be raised at the annual meeting through the chairperson and it may be sufficient to inform shareholders about this procedure rather than facilitating further access to auditors.

> *" .... There should be no additional facilitation. I cannot imagine that it would be in the interests of shareholder relations for a Chairman to refuse a question being put to the auditors by a shareholder."*

Others noted that auditors are engaged by companies to which they owe certain responsibilities, and that an auditor could be in a difficult position if approached by a shareholder about matters confidential to the company.

***Q: Do you support the view that institutional shareholders should always vote on shareholder resolutions?***

Opinion was divided on this.

Although there was strong support for the idea, respondents who qualified their support thought institutional shareholders should be encouraged to vote, but could not or should not be compelled.

> *"To vote or not is the shareholder's individual choice. This extends to so called institutional shareholders."*

It was noted that institutional shareholders are often in a better position than other shareholders to offer informed support or criticism. Some respondents said that institutions must consider whether they should take an active interest in the affairs of companies in light of their obligations to their own investors and stakeholders.

> *"Institutional shareholders have a duty to their investors to take part in the governance of major companies in which they invest.... Institutional investors need to start the process of good governance by taking part in the governance decisions and exercising their rights to speak and vote in companies in which they invest."*

There was also a strong view was that all shareholders have the right to vote or abstain, and that to create a category that is obliged to vote would upset this equality.

***Q: Should listed companies publish a formal policy on their relations with shareholders?***

Opinion was divided on this.

Some said that it would be good practice and would help to reinforce the rights and importance of shareholders in corporate structures. Others noted that while good practice, this should not be mandatory. Others said that, while publishing would do no harm, it should be simple and brief and not "fall into platitudes".

Views against publishing a policy included

- that it could become just "another piece of paper";
- that implementation is more important than publication; and
- that these policies can be a source of competitive advantage when effectively implemented, but that such advantage could be removed if publishing was made mandatory.

Several said that if a formal policy is not published, it is important that shareholders understand where they can access information and how they can raise concerns with a company. At the least shareholders need to be aware of their legal and procedural rights.

***Q: How well do you think that listed companies in New Zealand provide shareholders with comprehensive and easily understood commentary on their financial performance?***

A majority said that listed companies in New Zealand are "good" to "moderately good" at providing shareholders with comprehensive and easily understood information on financial performance.

> *"Our experience is that, on the whole, listed companies in New Zealand are conscious of the desirability of keeping a balance in the commentaries on financial [information] between detail, which shareholders unfamiliar with financial terminology can find overwhelming, and readability."*

Some people who stated that this was done well said that it was true particularly of the larger entities but that some small and medium-sized companies did not do it so well.

It was noted that financial reporting follows prescriptive rules that can challenge a company's ability to report in a way that is easily understood by the average investor. Also that there can be a conflict between comprehensive and easily understood information.

Some respondents said that the quality of reporting could vary. Others said that there was the potential for "masking" results and promoting complicating structures that could confuse people. Other comments were that the issues could get lost in the detail, that some reports were too technical, and that superfluities were being added that could cloud performance issues.

The fact that it can be difficult for companies to recognise the varied needs of shareholders was also raised. Some said that the market already treats those companies that communicate well in a favourable way and so there is an adequate incentive to report effectively, irrespective of prescriptive rules.

***Q: Should other business entities - such as co-operatives, large trusts and unlisted companies - provide more comprehensive public reporting on their performance?***

There was strong support for more comprehensive public reporting by these entities. However, some said that any such obligation should be triggered by specific factors, such as whether securities are issued by the entity and whether public money is involved.

> *"... the benefits of disclosure of trading performance and financial position go beyond the maintenance of an informed securities market. Accordingly if an appropriate platform for disclosure by unlisted entities could be established there may well be some benefits in such a proposal."*

Others said that the costs and benefits of increasing reporting obligations need to be studied.

It was argued that for a non-public issuer, disclosure should be a matter for shareholders or beneficiaries to decide. It was also noted that more public reporting of the performance of co-operatives and large trusts would be desirable if the structure and liquidity of their ownership were similar to those of public issuers.

Of those who did not support more comprehensive reporting by these entities, a number said that requirements under current law are satisfactory and that if an entity's structure entitles it to "privacy within the bounds of its shareholders", nothing more should be required.

***Q: Do you have any other comments on this issue?***

Several respondents commented that company analysts have an important role in accessing and conveying information about public companies. It was noted that smaller companies can have difficulty attracting research interest.

It was suggested that institutional shareholders have the potential to be influential in corporate governance, as do representative groups such as the New Zealand Shareholders' Association Inc.

Some commented on means of communication, with strong support for use of company websites to provide easy access to company information. It was noted that public conference calls following announcements of results could provide a useful opportunity to clarify information.
It was suggested that companies encourage shareholders to send in questions to be answered at the annual general meeting, and noted that some companies do this already.

*Views by type of entity*

People from listed companies were more likely to support the adequacy of current communications mechanisms with shareholders. Those from professional firms and those responding in a personal capacity were more likely to suggest improvements.

While acknowledging scope for improvement, people from listed companies and professional firms had typically positive views on the extent to which financial reporting by listed companies is comprehensive and easily understood.

A small number of respondents who disagreed on this matter were representatives of some associations, and some professional firms and a few responding in a personal capacity.

## ISSUE NINE: Stakeholder Interests

**Key findings from respondents**

- Shareholder interests are paramount but companies should consider the interests of other stakeholders.
- Stakeholder interests include employee, environmental, social, and economic matters.
- Public sector bodies have a wide range of stakeholder obligations set out in law.
- Opinion was divided over whether stakeholder interests should be dealt with by boards or by management.
- Companies should have policies about stakeholder interests.

***Q: To what extent do you agree with the view that while shareholders have the primary interest in a company, there are other stakeholders whose interests should be considered in the context of corporate governance?***

There was strong support for the view that companies should consider the interests of people other than shareholders. However, this support often had some proviso, for example "provided the interests of shareholders are paramount" or "should be considered but not mandated".

> *"We firmly agree with this view however, there needs to be the recognition of the responsibility of directors ... to act in the best interests of shareholders."*

Some supported companies taking account of social and environmental issues, and also the interests of creditors, employees, suppliers and customers.

Some put forward the concept of a social "licence to operate" on the basis that large companies have a significant impact on the community and the economy and should have a broader view of accountability. Others said that the responsibility for identifying parties who have a key or material impact on company performance or code of ethics should rest with boards and not be prescribed.

It was recognised that the range of stakeholders is wider for public sector bodies than for companies. It was noted that these bodies already have a legal obligation to consider stakeholder issues.

Several said that the interests of stakeholders should not become a legal duty and that there is no need to over-regulate. It was noted that the scope of people with a "legitimate interest" is potentially very broad. Others said stakeholder interests should only be considered to the extent that doing so adds to shareholder value.

Some disagreed. Of these people, most said that boards should answer to shareholders only. The view was also expressed that stakeholder interests should only be a matter for management. Others said that stakeholder groups are protected by legislation, such as the Fair Trading Act 1986.

***Q: Should the interests of other stakeholders be actively considered by New Zealand boards? If is, how should these interests be addressed?***

While some people disagreed, the majority thought that boards should consider the interests of other stakeholders.

Of those who offered qualified support, some said that other stakeholders' interests should be considered but how actively this is done should be a matter for boards to decide. Reporting on performance should also be at the discretion of boards. Others commented that shareholder interests need to remain paramount.

Of those who disagreed some said that such interests are already considered and dealt with through legislation and it should not be part of a board's compulsory functions. It was suggested that stakeholder interests be considered only if there is a direct economic connection with the company.

A majority thought that companies should have formal policies or codes for dealing with stakeholder interests, although opinion was divided on whether these should be implemented at board or management level.

Some suggested that stakeholders' interests would best be addressed through disclosure, such as triple bottom line reporting or social impact statements. Others said they expected to see some reference to stakeholder interests in annual reports.

It was suggested that formal consultation is appropriate for some stakeholders, such as employees.

It was noted that stakeholder interests should be addressed by disclosure in statements of intent by public sector bodies.

***Q: Do you have any other comments on this issue?***

Comments included

- that companies should have a broader accountability than can be achieved through a narrow focus on shareholders;
- that stakeholder interests are a matter of ethical conduct for a company;
- that recognition of stakeholder interests is simply a matter of good business sense, and should be addressed in the normal business planning of a company;
- that the potential range of "stakeholders" for any company is very broad; and
- that confusion would result if stakeholder interests were placed on a par with those of shareholders.

***Views by type of entity***

There were no underlying trends apparent relating to entity type and perspectives on addressing stakeholder interests.

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