

# **CORPORATE GOVERNANCE IN NEW ZEALAND PRINCIPLES AND GUIDELINES**

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A HANDBOOK FOR DIRECTORS, EXECUTIVES AND ADVISERS

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PRINCIPLES AND GUIDELINES

**A Handbook for Directors,  
Executives and Advisers**

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# **Principles for Corporate Governance**

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

## Introduction

The Securities Commission published a report *Corporate Governance in New Zealand Principles and Guidelines* in February 2004. The report sets out nine Principles of corporate governance for application within a broad range of entities.

The 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.

The report also sets out guidelines on the types of corporate governance structures and processes that will help entities achieve each Principle. It explains the Commission's view on each area covered and includes detailed information on the extensive consultation carried out prior to publication.

The report is available from [www.sec-com.govt.nz](http://www.sec-com.govt.nz) or in hard copy from the Securities Commission on telephone 04 472 9830.

This Handbook is a shortened version of the report *Corporate Governance in New Zealand Principles and Guidelines*. It is intended as a reference for directors, executives and advisers, as they decide how best to apply the Principles to their particular entity. The nine Principles and their accompanying guidelines are included together with the Commission's view on the particular area of corporate governance.

Copies of this Handbook are also available from the Securities Commission's website [www.sec-com.govt.nz](http://www.sec-com.govt.nz) or by telephoning 04 472 9830.

## Who the Principles Apply to

The Principles can 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.

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 Commission's primary focus is on issuers of securities. 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 all issuers to observe and to report on to their investors and other stakeholders.

Issuers who are publicly owned entities have particular corporate governance responsibilities to their shareholders. The term “publicly owned entity” is used in this Handbook to describe public companies and other entities, such as collective investment schemes, which have investors with similar ownership interests to company shareholders, and similar rights to vote on matters affecting the entity. The term “shareholders” includes these investors.

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 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.

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.

## **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 fulfill its governance responsibilities, and how it has used them.

The guidelines are intended to help entities think about how they can achieve each Principle. We do not expect entities to report specifically 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 be already addressing 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 the 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.

# **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.

### **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.

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## **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.

### **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.

#### **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.

## 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.

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## **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.

## 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.

### **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.

## 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 brought 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 accompanied 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.

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## **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.

### 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 web cast.
- 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.

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## **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**

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

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.

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.

### **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.

