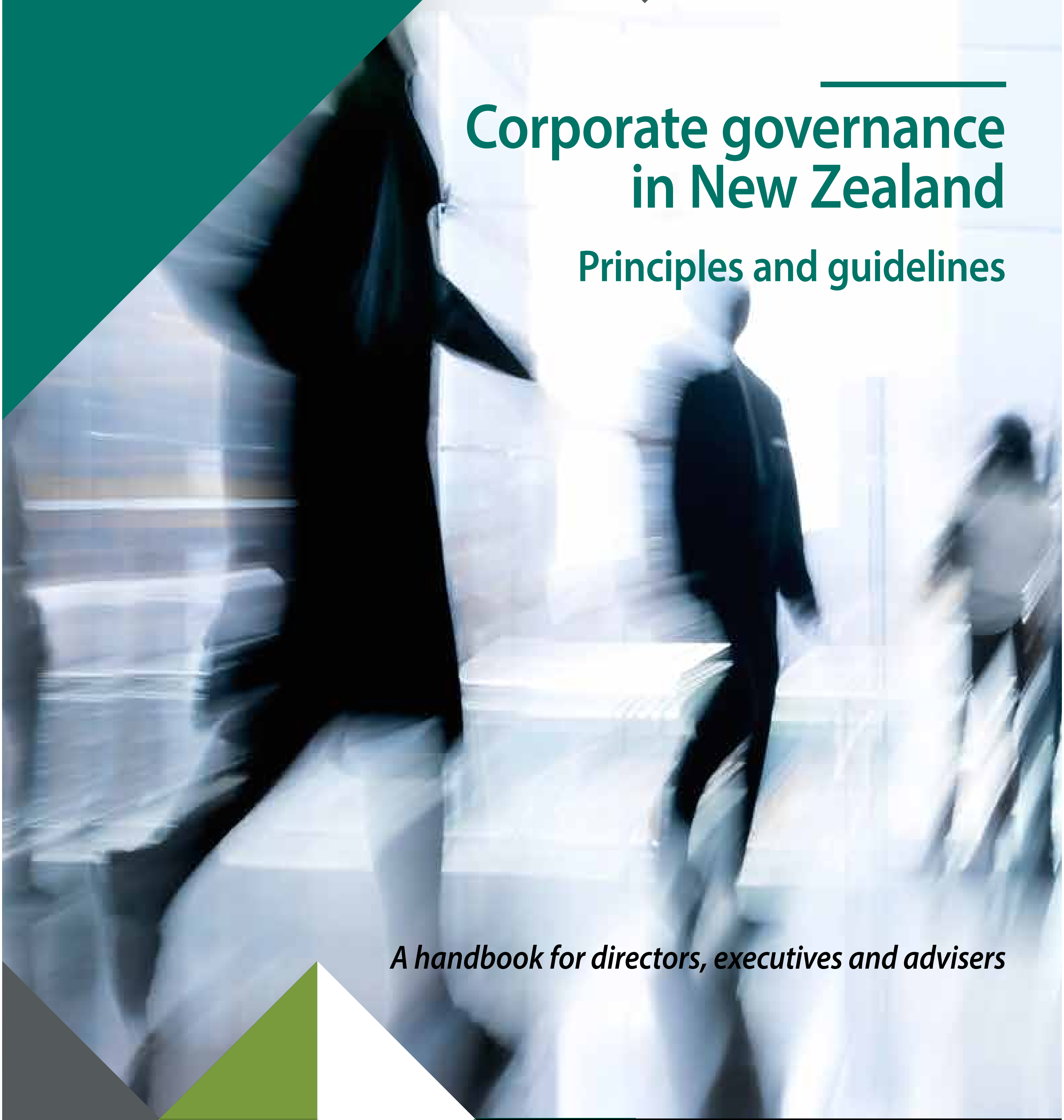
Corporate governance in New Zealand

Principles and guidelines



A handbook for directors, executives and advisers

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND

Contents

Principles for corporate governance

1
Ethical standards
Directors should set high standards of ethical behaviour, model this behaviour and hold management accountable for delivering these standards throughout the organisation.

2
Board composition and performance
To ensure an effective board, there should be a balance of skills, knowledge, experience, independence and perspectives.

3
Board committees
The board should use committees where this will enhance its effectiveness in key areas, while still retaining board responsibility.

4
Reporting and disclosure
The board should demand integrity in financial and non-financial reporting, and in the timeliness and balance of corporate disclosures.

5
Remuneration
The remuneration of directors and executives should be transparent, fair and reasonable.

6
Risk management
Directors should have a sound understanding of the key risks faced by the business, and should regularly verify there are appropriate processes to identify and manage these.

7
Auditors
The board should ensure the quality and independence of the external audit process.

8
Shareholder relations and stakeholder interests
The board should respect the rights of shareholders, and foster constructive relationships with shareholders and stakeholders. Shareholders should be encouraged to engage with the entity.

Introduction

This handbook assists directors, executives and advisers of non-listed and public-sector companies, and other entities, to apply corporate governance principles to their particular entity.

Corporate governance comprises the principles, practices and processes that determine how a company or other entity is directed and controlled. Good corporate governance supports investor confidence. It contributes to our role of regulating capital and financial markets in New Zealand. It is also critical to our overall purpose of promoting and facilitating fair, efficient and transparent financial markets.

How an entity approaches corporate governance will depend on the nature and purpose of the entity's business, operating environment and stakeholders. We recognise that a 'one-size-fits-all' approach is not appropriate for every type of entity. This handbook is intended to assist those in governance roles for New Zealand non-listed and public-sector companies and other entities ('companies and entities') to think about, apply and report on corporate governance.

Good corporate governance allows directors and executives to focus on growth, value creation and long-term sustainability.

Who should read this handbook?

Broadly, the principles can be useful to all companies and other types of entities. We are most keen to see the principles considered by entities with an involvement in New Zealand's financial markets. This may include:

- companies wanting to raise capital and/or list on the NZX in the future
- companies providing financial services
- issuers of unlisted securities
- state-owned enterprises
- community trusts
- public-sector entities
- Māori and iwi-owned entities
- large non-government organisations
- not-for-profit organisations and charities
- other companies.

Refining our focus

We last published this handbook in 2014. That version provided advice for listed and unlisted companies.

In 2017, the NZX published an updated corporate governance code (the NZX Code) for companies listed on their licensed markets. This was based on our 2014 handbook.

We now view the updated NZX Code as the primary guidance on corporate governance practices for NZX-listed companies. Therefore we have refocused our handbook on non-listed companies and entities, many of which have a significant impact on New Zealand's financial markets.

We want to provide their directors and executives with a practical guide to applying corporate governance principles.

We will continue to engage with the NZX and listed companies to ensure corporate governance standards continue to rise. We will also continue to take appropriate action where we find examples of poor governance.

Additional governance obligations apply to the boards of issuers of debt securities, managers of managed investment schemes and their supervisors under the Financial Markets Conduct Act ('FMC Act'). This handbook may be useful to these groups as they review their governance frameworks against their FMC Act obligations.

Our approach

Principles

The principles do not impose any new legal obligations, and reporting against them is voluntary. However, the principles do set out standards for corporate governance that we believe directors and executives should apply, and report on, to their investors, shareholders and stakeholders.

The principles are in no particular order of priority. Principles 1 to 7 deal with how directors should govern. Principle 8 deals with the board's relationship with shareholders and other stakeholders. The handbook focuses on principles rather than checklists or rules.

Not all principles will wholly apply to all entities. Directors and executives should consider the nature and needs of their businesses when they consider the relevance of each principle and how to apply it.

For instance, public-sector organisations do not have shareholders in the traditional sense and are subject to specific board appointment processes. However, they are accountable to one or more responsible ministers, their stakeholders and the New Zealand public. These entities should apply the principles to the fullest possible extent, except where they are subject to competing statutory or public policy requirements.

As these principles are broad and high level, we suggest boards explain to investors and stakeholders how they have applied each principle. The 'comply or explain' approach of the NZX Code is appropriate for listed companies. The 'explain' approach of this handbook is intended to cater for reporting by the broad range of entities that may use this handbook

Guidelines and commentary

This handbook also provides guidelines and commentary for each principle, as the NZX Code does.

Guidelines assist directors and executives by providing examples, and detail, of the types of rules, practices and processes that may help them explain how they apply the principles.

Our commentary provides context and other information to assist directors and executives in understanding why it is important to apply a particular principle.

Other useful publications

The Institute of Directors' Code of Practice for Directors, and The Four Pillars of Governance Best Practice contain high-level principles of governance best practice, plus practical guidance on day-to-day directorship.

The NZX Corporate Governance Code provides guidance for listed companies.

Directors and executives of companies and entities thinking of listing on the NZX in future can refer to our publication Going public, a director's guide to IPOs. This guide helps directors and executives assess whether going public is appropriate for their entity. It also outlines the process of becoming a public company.

Entities which have market services licences under the Financial Markets Conduct Act 2013 ('FMC Act') may wish to refer to our Guide to the FMA's view of conduct for further commentary on governance.

Public sector entities may wish to refer to guidance provided by the State Services Commission.

Throughout this handbook we use the term 'entity' to refer broadly to any type of company or organisation the principles apply to.

How to report against the principles

All entities should report how they apply the principles

Good corporate governance relies on transparency and disclosure. Implementing the principles therefore also requires reporting on corporate governance practices to shareholders and other stakeholders. For most entities this can be achieved in their annual report or on their website. Company websites should have comprehensive, easily accessible corporate governance sections. We encourage entities to keep their information current throughout the year and update key information and disclosures whenever something changes.

Although reporting against these principles is voluntary, if entities do wish to report they should explain which principles they have applied and how. If appropriate, they should also explain which principles they are in the process of adopting, or working towards adopting.

Reporting should include a brief description of the structures and processes put in place by the board to help fulfil its governance responsibilities, and how these processes were used.

Directors are encouraged to consider their, and the entity's performance, against each principle before information is prepared. The principles should be 'owned' by the board, and not delegated to management as a 'tick-box' compliance exercise.

Boards should discuss and measure their performance against the principles each year, including making any suggested improvements.

Formal corporate governance reporting may be new to some smaller entities. However, all entities should think about their corporate governance practices.

Some smaller entities may decide that only some principles apply to them, and it may take time for these entities to implement and report against the principles. In the meantime, we think it would be helpful for them to report to their investors and stakeholders on progress made towards observing and reporting on each principle.

We do not expect entities to report against the detail in the guidelines. Reporting should instead show how an entity has applied the eight principles.

Principle 1

Ethical standards

Directors should set high standards of ethical behaviour, model this behaviour and hold management accountable for delivering these standards throughout the organisation.

Guidelines

1.1 Boards should adopt a written code of ethics that is a meaningful statement of the entity's core values. A code of ethics needs to suit their particular circumstances and needs. The code should set out explicit expectations for ethical decision-making and personal behaviour.

Key areas it should cover include:

- acting honestly and with high standards of personal and professional integrity
- dealing with conflicts of interest[1], including any circumstances where a director may/may not participate in board discussion, and voting on matters in which a director has a personal interest
- proper use of an entity's property and/or information, including not taking advantage of the entity's property or information for personal gain, except as permitted by law
- not participating in illegal or unethical activity
- fair dealing with customers, shareholders, clients, employees, suppliers, competitors and other stakeholders
- restrictions on giving and receiving gifts, koha, facilitation payments and bribes
- complying with applicable laws and regulations, including restrictions on share dealing by directors
- reporting unethical decision-making and/or behaviour
- conduct expected of management and the board for responding to and supporting whistleblowing.

1.2 The code of ethics should include processes for recording and evaluating compliance and for dealing with breaches of the code.

1.3 Entities should communicate the code of ethics to their employees, and support their compliance with training and clear procedures.

1.4 Entities should publish the code of ethics and report on steps taken to implement and monitor compliance with it. Reporting should include action taken on serious breaches.

1.5 Boards should have a system to implement and review the code of ethics. They should monitor adherence to the code and ensure directors, executives, and other personnel are held accountable for acting ethically.

1. It may also be useful to refer to the Conflicts of Interest Practical Guide published by the Institute of Directors in New Zealand.

FMA commentary

Ethical behaviour is central to all aspects of good corporate governance[2]. Good governance structures encourage high standards of ethical and responsible behaviour. However, they can only be effective when directors and boards commit to the same standards.

The benefits of a code of ethics

Widespread adoption and implementation of codes of ethics by entities will help promote public confidence in governance structures and behaviour.

It is our view that, as a minimum, a code of ethics should address the matters set out in the guidelines on page 8. Depending on the entity, there may be other matters that should be included. As circumstances change, an entity should review, expand or update its code of ethics to ensure relevance.

A code of ethics will not create ethical and responsible practices. It is simply a guide and reminder of expected behaviour. It aims to set standards against which behaviour can be judged. A code is ineffective unless directors and employees put it into practice. Boards need systems and processes to implement the code, and then monitor its effectiveness. This could form part of boards' annual performance assessments.

Ultimately, boards are responsible for ethical behaviour in the entity. Larger boards may consider establishing an ethics committee to assess performance (including directors' and employees' performance) against the code of ethics.

We also encourage entities to have their code independently verified on a regular basis to check implementation and effectiveness.

Transparency encourages ethical behaviour by increasing accountability. This is enhanced if codes of ethics are published alongside meaningful information that explains how the code was implemented, and monitors compliance. This reporting should include, in general terms, information about any serious instances of unethical behaviour in the entity, and the steps taken to deal with this.

2. It may also be useful to refer to the report on ethical business leadership from a New Zealand perspective published by the Institute of Business Ethics.

Principle 2

Board composition and performance

To ensure an effective board, there should be a balance of skills, knowledge, experience, independence and perspectives.

Guidelines

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

2.2 Every board can benefit from an appropriate balance of executive and non-executive directors. We encourage boards to include directors who meet formal criteria for an 'independent director'.

2.3 All directors should, except as permitted by law and disclosed to shareholders, act in the entity's best interests.

2.4 Boards should have a formal charter setting out their roles and responsibilities, and those of directors, including formal delegations to management.

2.5 Board chairs should be formally responsible for fostering a constructive governance culture and ensuring directors and management apply appropriate governance principles.

2.6 We recommend the chair be independent. No director should simultaneously be a chair and chief executive of the entity (or equivalent). Only in exceptional circumstances should the chief executive go on to become the chair.

2.7 Boards should be satisfied directors will make the necessary time commitment to be effective in their role.

2.8 Boards should set out, in writing, the specific expectations of non-executive directors (including independents).

2.9 Boards should allocate time and resources for directors to gain and retain a sound understanding of their responsibilities. New appointees should have a comprehensive induction, and all directors should have ongoing training.

2.10 Boards should have rigorous formal processes for evaluating their performance, and that of board committees, individual directors, and the chair. This could include a formal, regular review of the chair.

2.11 Reporting should include information about each director. This would include a profile of their experience, length of service, independence and ownership interests in the entity. It should also include information on the board's appointment, training and evaluation processes.

FMA commentary

The board guides the strategic direction of the entity, and directs and oversees management. The size of the board should be appropriate to meet the needs of the entity. Each director should have skills, knowledge and experience relevant to the entity's business.

An effective board requires its members to have a range and variety of relevant attributes which complement each other. This includes a diversity of gender, ethnicity, cultural background, age and skills.

Boards should consider using a skills and capability matrix to identify current and future skill and diversity needs of the entity. The entity should be able to explain to shareholders how the skills and experience of proposed board appointees will support the achievement of strategic objectives. Boards should report on composition and succession planning at least once a year.

'Independence of mind' is a basic requirement for board directors. Each director must aim to have an independent perspective when making judgments and decisions on board-related matters. This means a director puts the interests of the entity before any other interests, including those of management or individual shareholders (except as disclosed and permitted by law). Directors with an independent perspective are more likely to constructively challenge each other and executives – increasing their effectiveness.

Non-executive directors and independence

Non-executive directors, who do not have other interests that could affect their judgment or decision-making, can bring an independent perspective to board decisions. We encourage entities to establish and publish clear criteria which defines an 'independent director'.

Independence should be considered along with the other necessary attributes needed in a non-executive director. Formal independence is not beneficial, on its own, if the non-executive director doesn't have independence of mind, and the appropriate skills, knowledge, experience and time for the role.

Factors influencing independence

There may be practical constraints in New Zealand in setting the level of formal independence too high. However, New Zealand investors should have confidence in director independence. The underlying issues related to director independence can be addressed by:

- directors having an independent perspective when they make decisions
- only classifying non-executive directors as 'formally independent' where they do not represent a substantial shareholder or other key stakeholder. The board must also be satisfied the non-executive director has no other direct or indirect interest or relationship that could reasonably influence their judgment and decision-making
- having an independent chairperson

- boards taking care they meet all disclosure and reporting obligations concerning directors and their interests, including information about the directors, identifying which directors are independent, and describing the criteria used to assess independence.

Other factors that may impact director independence are:

- recently being employed in an executive role by the entity or any of its subsidiaries
- recently holding a senior role in a provider of material professional services to the entity or any of its subsidiaries
- a recent or current material business or contractual relationship (eg supplier or customer) with the entity or any of its subsidiaries
- having close family ties with anyone in the categories listed above
- having been a director of the entity for a length of time that may compromise independence.

If a company or entity intends to raise capital and/or list its shares on a public market in the future, (or has a significant role in New Zealand's financial markets), we encourage them to either have the following on their boards – or be working towards this:

- a majority of non-executive directors
- a minimum of two independent directors or one-third of the board for larger boards.

Executives

It is also important to recognise the contribution of executives. Their skills and perspectives provide a sound basis for challenge by non-executive directors. Having executives on boards or at board meetings promotes constructive discussion between directors and executives, making boards more effective.

Entities can maintain proper balance between executive and non-executive directors by holding regular meetings for non-executive directors. This allows them to share views and information without executives present.

Tenure

We encourage boards to consider each director's length of service and the impact it may have on their independence.

Regular reviews of board members' tenure also improve boards' ability to strike the right balance between institutional knowledge and fresh thinking. It helps to ensure the board has the right mix of skills that the entity currently requires. This should be an integral part of succession planning.

Roles and responsibilities for the board and executives

If the respective roles of the board and executives are well understood by everyone, efficiency and accountability are improved.

A board charter can be helpful to set out the responsibilities of the board and its directors, and capture details of any delegations given by the board to management. Entities may wish to redact commercially sensitive delegations before the board charter is published.

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

Role of the chair

The chair is critical in director-executive relations. Their role includes promoting cooperation, mediating between different perspectives, and leading informed debate and decision-making. The chair should lead the process of evaluation and review of the board's performance.

The chair also has a pivotal role between the chief executive and the board. The balance between these roles is important. It works best if the roles of chair and chief executive (or equivalent) are clearly separated, and the chair is an independent director.

In general, the chief executive should not go on to become the chair. Only in special circumstances should this occur, for example where an individual has the skills, knowledge and experience not available elsewhere to the entity. These circumstances should be fully explained to investors and stakeholders.

Nomination committees

The optimum number of directors depends on an entity's size, the nature and complexity of its activities, and its requirement for independent directors. If a board is too large decision-making may become unwieldy; if it is too small it may not achieve the necessary balance of skills, knowledge and experience.

In larger boards, a separate nomination committee can help to focus resources on maintaining an appropriately sized and skilled board, as well as advising on tenure and succession planning for existing directors.

Being an effective board member

It is important that non-executive directors understand their expected roles and responsibilities, especially if they have no prior knowledge of an entity.

An induction programme, and a written statement of expectations for each non-executive role, including the expected time commitment, will help in this area.

Principle 3

Board committees

The board should use committees where this will enhance its effectiveness in key areas, while still retaining board responsibility

Guidelines

3.1 Board committees should have a clear, formal charter setting out their role and delegated responsibilities. It should make clear the function of the committee is not to replace the ultimate decision-making authority of the full board.

3.2 The charters and membership of each board committee should be available on the entity's website.

3.3 Committee proceedings should be reported back to the board to allow other directors to question committee members.

3.4 For larger entities, it may be appropriate to have an audit committee. It would have the following responsibilities:

- recommending the appointment of external auditors
- overseeing all aspects of the entity-audit firm relationship
- promoting integrity and transparency in financial reporting.

Where possible, audit committees should comprise:

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

The chair of the audit committee should not have a longstanding association with the external audit firm either as a current or retired audit partner or senior manager at the firm. An exception could be made if the association could no longer reasonably be perceived to influence either the chair or the external audit firm.

In our view an audit committee chair previously employed by the external audit firm would be perceived to be influenced for at least three years, and often longer, after leaving the firm[3].

3. The audit standards include a compulsory minimum one-year stand-down period for certain audit firm staff. However, this minimum period should not be considered sufficient in most cases.

FMA commentary

Board committees may not be appropriate or practical for all entities. However, in large or more complex companies, board committees can significantly enhance effectiveness. A committee can facilitate closer scrutiny of issues and more efficient decision-making. Committees maximise directors' skills, knowledge and experience, and can help spread the workload among directors.

A committee should have an effective relationship with the board. Committee members should clearly understand the committee's purpose and role. Members should also be clear about the extent of any formal delegations from the board.

A conflicts of interest register should be maintained for all board members and committees. The register should record interests that may be in conflict with the entity.

The board is ultimately responsible for its committees and their work. The board should be well informed about decisions for which it is ultimately responsible. Committee proceedings should be reported back to the board. Non-committee directors should have the opportunity to comment on the committee's business, or have it explained to them, where necessary.

Audit committees

The structure of an audit committee is particularly important, in terms of independence and skills required.

Financial reporting and audit processes are a key area of board responsibility. Audit committees can be an important tool for entities.

Remuneration committees

Entities, especially those with larger boards, can 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 should recommend to the board (or have delegated responsibility for) an appropriate approach to valuation and disclosure. The remuneration committee should have a majority of independent directors.

Other committees

Other areas of board performance could also be improved by having committees.

Establishing a risk committee is something entities should consider, in particular. For smaller entities, it may be appropriate to combine committees, for example, having a combined audit and risk committee.

Our commentary on Principle 2 includes information about the benefit of a nomination committee. A health and safety committee may also be useful to provide accountability for safety procedures, policies and legislative compliance.

It is vital that boards give proper time and attention to these matters. Committee decisions must be robust and transparent. Entities, particularly those with large boards, should consider if using committees would enhance their effectiveness in the important areas mentioned above.

Principle 4

Reporting and disclosure

The board should demand integrity in financial and non-financial reporting, and in the timeliness and balance of corporate disclosures.

Guidelines

4.1 Boards should have a rigorous process to ensure the quality and integrity of financial statements and non-financial reporting.

4.2 Financial reporting and 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. We encourage boards to make their financial reports clear, concise and effective; while meeting the requirements of financial reporting standards.

4.3 Boards should determine the appropriate level of non-financial reporting, considering the interests of their stakeholders and material exposure to environmental, social and governance (ESG) factors. All boards should maintain an effective system of internal control for reliable financial and non-financial reporting and accounting records.

4.4 Directors should explain their role in preparing the annual report, and in preparing financial statements that comply with relevant laws and accounting standards.

4.5 Where appropriate, an entity should make its code of ethics, board committee charters, ESG reporting and other governance documents readily available to investors and stakeholders online.

4.6 Public-sector entities are required to report each year on how they have served the interests of their public stakeholders.

FMA commentary

High standards of reporting and disclosure are essential for proper accountability between an entity and its investors and stakeholders. Accountability is an incentive for good corporate governance.

Reporting and disclosure encompasses both financial and non-financial reporting. Although these guidelines make a distinction between financial and non-financial reporting, we recognise the two can be interconnected. Together, they provide a comprehensive understanding of an entity's overall performance, and related risks and opportunities.

Financial reporting

The quality and integrity of financial reports are reflected in how easily users can understand them.

Legal and regulatory requirements establish baseline expectations for reporting and disclosure. Good corporate governance includes compliance with these requirements and a commitment to ensuring investors and stakeholders (or recipients of public-sector reports) are sufficiently informed to properly assess entities and boards.

Boards are directly responsible for the quality and accuracy of financial reports. This requires adopting appropriate accounting policies and implementing appropriate controls and processes to ensure records are complete and accurate.

These processes should include certification by the chief executive, and chief financial officer (or equivalent officers). They are principally accountable to directors, who have ultimate responsibility for financial reports.

Executives' accountability is further strengthened by the chief executive and chief financial officer certifying the published financial statements.

Directors retain liability for the financial statements. They should have sufficient understanding to challenge and enquire about the accuracy and completeness of financial reports from management and experts, particularly where financial information does not reflect their understanding of the substance of particular arrangements.

Having an audit committee (Principle 3) and independent auditors (Principle 7) contributes significantly to the overall process, and ultimately the quality and integrity of financial reports.

Reporting and disclosure requirements are particularly important for public-sector entities, issuers of securities, and entities which provide financial services. However, other entities could adopt similar standards in the form and timeframe best suited to their legal form, types of business, stage of development, and users of their financial reports.

Non-financial reporting

To demonstrate long-term value creation, boards should determine the appropriate level of non-financial reporting. Entities are encouraged to disclose policies and performance relating to ESG issues.

Where appropriate, entities should report on material topics such as social and environmental issues, business ethics, and other relevant topics identified and assessed through a materiality determination process.

Non-financial reporting can also include a description of the entity's performance against its strategic goals. This should enable a meaningful understanding and analysis of strategy, and execution against the strategy.

These examples of non-financial reporting are important as they help investors and stakeholders to assess the relationship between an entity and the communities it affects. This is because ESG factors, while they can be classified as non-financial, may have a financial impact through, for example, increasing costs or threatening an entity's 'licence to operate'.

Entities can adopt a formal framework to report on ESG factors or report on those factors together with the financial information. Such frameworks may include the Global Reporting Initiative guidelines or the International Integrated Reporting Framework.

If it is impractical to adopt a formal framework, as an alternative, entities could select specific non-financial matters to report on.

With or without a formal framework, entities should aspire to disclosure that reflects the full range of factors and risks relevant to their operations, and appropriately balances financial and non-financial reporting.

Principle 5

Remuneration

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

Guidelines

5.1 Boards should have a clear policy for setting executive and director remuneration. Remuneration should be fair and reasonable, and competitive in the market for the skills, knowledge and experience required.

5.2 Entities should disclose their remuneration policies to shareholders.

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

5.4 Executive (including executive director) remuneration packages should be appropriately aligned with the entity's strategy, and include an element dependent on entity and individual performance.

FMA commentary

Adequate remuneration is necessary to attract, retain and motivate high-quality directors and executives. It is generally expected such remuneration will be reflected in enhanced entity performance.

Setting appropriate levels of remuneration for directors and executives is particularly complex and an entity's individual context is critical. Every board should have policies and processes for setting remuneration and remuneration reporting (including disclosures required under the Companies Act 1993).

Shareholders want to see remuneration policies that allow for the right directors and executives to be appointed, and that remuneration is reasonable.

Remuneration policies should be disclosed to help shareholders to assess this. Entities should also disclose total remuneration and a full breakdown of any other benefits and incentives paid to directors. This breakdown should include short-term and long-term incentives[4].

Remuneration of directors and non-executive 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 part of an executive director's remuneration is linked to entity performance over time, their efforts are more likely to be focused on making a contribution to future investor returns rather than short-term gains. Their remuneration may include shares or options to reflect this longer-term view.

Usually, non-executive directors' remuneration is paid as fees. It should be based on the value of their services and not the length of service. Any benefits received should be disclosed to shareholders.

For non-executive directors, retirement payments should not be provided other than superannuation.

Our commentary in Principle 3 includes information about the benefits of a remuneration committee.

4. Also see the Institute of Directors' Guide to disclosing director remuneration in annual reports.

Principle 6

Risk management

Directors should have a sound understanding of the key risks faced by the business, and should regularly verify there are appropriate processes to identify and manage these.

Guidelines

6.1 Boards should ensure there are rigorous risk management processes and internal controls in place.

6.2 Boards should receive and review regular reports about the risk management framework and internal control processes, including any developments about material risks.

6.3 Board reports should include a copy of the entity's risk register and should highlight the main risks to the entity's performance and the steps being taken to manage them.

6.4 Boards should report on risk identification, risk management and relevant internal controls to investors and stakeholders, at least once a year.

FMA commentary

Taking appropriate risks is an essential feature of business. All entities have various risks they need to identify and choose how to manage or avoid. Risk management is a critical responsibility for boards.

To be effective, boards should be aware of and properly assess the nature and magnitude of risks faced by the entity.

Processes to manage risks

Risk management frameworks are essential for the coordinated identification, monitoring and management of risks.

Companies globally and in New Zealand are facing increasing calls to consider ESG matters in their identification and management of risk. This is, partly, driven by calls from investors for greater transparency about the types of risks they face. Greater transparency means investors can better assess risks to their capital.

We recommend entities consider ESG matters as part of their risk assessment. Entities should report on what circumstances exist or could arise to materially increase the risks to their strategy or plans, and how they currently manage or intend to manage those risks.

Entities may adopt a formal framework to report on ESG factors (as outlined in Principle 4) or use other forms of reporting.

We also encourage entities to develop and maintain a risk register to identify material risks. It should record the likelihood and impact of each risk, and highlight the steps taken to mitigate each one. This enables boards and managers to be properly informed and implement internal processes that are responsive to existing or emerging risks.

These processes would normally operate in conjunction with internal control structures, depending on the size and circumstances of the entity. A separate risk management function or committee may be appropriate for larger entities.

An internal audit function can complement effective risk management and internal controls for entities that face significant financial, operating and compliance risks.

Entities should report on risk management at least once a year to investors and stakeholders. Reports should detail how the board effectively oversees risk and how key risks are managed. This could include individual strategies for managing more significant risks, and details on the board’s appetite for risk in material areas.

Our commentary in Principle 3 includes information about the benefits of having a separate risk committee.

Principle 7

Auditors

Boards should ensure the quality and independence of the external audit process.

Guidelines

7.1 Boards should have a good working knowledge of the responsibilities of external auditors. They should be rigorous in their selection of auditors, based on professional merit.

7.2 The board should be satisfied there is no relationship between the auditor and the entity (or any related person) that could compromise the auditor's independence.

7.3 The board should facilitate regular and full dialogue between its audit committee, external auditors and management.

7.4 No issuer's audit should be led by the same audit partner for more than seven consecutive years.

7.5 Boards must prepare and file financial reports as required under relevant legislation. They should report to shareholders and stakeholders, once a year, on the fees paid to their audit firm. This report should differentiate between audit fees and fees for individually identified non-audit work (for example, separating each category of non-audit work, and disclosing the fees for this).

7.6 Fee negotiations should be managed by the directors and/or the audit committee. They should not be delegated to the entity's management.

7.7 Boards should explain in their annual report the non-audit work their audit firm carried out, and why the work did not compromise auditor objectivity and independence.

They should also explain:

- how they satisfied themselves about auditor quality and effectiveness of the audit
- their approach to tenure and reappointment of auditors
- any threats to auditor independence and how those threats were mitigated.

FMA commentary

High-quality external auditing is critical to the integrity of 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 in an entity who play a role in financial reporting.

Boards and their appointed auditors are jointly responsible for ensuring 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
- facilitate access to information and personnel.

Guidance for directors on how they can help improve audit quality can be found in our publication Audit quality – a director's guide.

The role of the audit committee

The audit committee has a crucial role in selecting and recommending board and shareholder appointment of auditors, and overseeing all aspects of their work. The committee should ensure there is a common understanding with the auditors about the scope of audit engagements and the evidence they will expect to be able to find when testing judgments applied to financial statements.

When selecting auditors, boards should ask if the FMA has carried out a quality review of the audit firm. If they have been reviewed, boards should ask if any issues were identified, and how the firm has addressed these issues.

Rotation of auditors is important to ensure independence and objectivity over time. This needs to be balanced against the costs of engaging a new auditor. Costs of a new auditor are necessarily higher until the firm becomes familiar with the entity and its business. Retaining some continuity will increase the auditor's knowledge of the entity.

Professional and ethical standards for auditors require seven-yearly partner rotation. This rotation should cover both lead and key audit partners. However, it does not necessarily need to include rotation of the audit firm itself.

This helps to strike a balance between cost, efficiency and independence. However, directors should still consider whether their relationship with the audit firm and/or key audit staff has become too close to provide sufficient challenge. If so, it is preferable to change audit firms.

Non-assurance work

Directors need to think carefully before they request 'non-assurance' services[5] from their external auditors.

Limiting non-assurance work done by an audit firm helps maintain independence and objectivity.

There is a diversity of views in New Zealand and internationally about the types of non-assurance work that should be restricted, and how this should be done. One core measure is that an audit firm should not undertake any work for an audit client that

5. Non-assurance services are work that is not part of the audit or a similar review or compliance engagement.

compromises, or could be seen to compromise, the independence, objectivity and quality of the audit process.

When considering independence, the audit committee should take into account what a reasonable and informed third party would conclude about the audit firm's independence, taking into account the specific circumstances. The fees paid for non-assurance work will be a factor in determining independence.

Non-assurance services often create self-review threats for the auditor, in addition to other potential threats to independence. The audit committee should consider whether all threats are sufficiently mitigated. Using different teams within the same audit firm to perform non-assurance services will not necessarily mitigate these threats.

Entities should ensure their disclosure in financial statements about non-audit work gives investors an informed view of the auditor's independence. The audit committee should also provide feedback to the full board regarding auditor independence. Feedback should cover non-assurance work and other threats to the auditor's independence.

Auditor independence

Auditor independence is crucial for investors, who rely heavily on this external assurance. If boards allow auditors to carry out non-assurance work, they must be accountable to investors and disclose this.

This accountability can be achieved by including a statement as to why, in their opinion, any non-assurance work or other threats to independence, such as a long association and close relationship between a member of the audit committee and the audit firm, do not impinge on the independence of the auditor. This statement can be in the entity's annual report. It should also include disclosure of all non-audit fees paid to the auditor as required by the professional standards.

Dealing with complaints

The audit committee has a crucial role in dealing with any complaints or disputes that may arise between the auditors and the entity.

The committee should have a process for dealing with auditors' complaints, such as complaints about access to relevant information held by management. The committee should also listen to employees or others who raise a concern about auditor independence and objectivity being compromised. This includes whistleblowing, by individuals acting in good faith, about external and internal audit processes.

The Companies Act 1993 allows auditors to report directly to shareholders where reappointment is not sought, or where the entity seeks to remove an auditor.

Principle 8

Shareholder relations and stakeholder interests

The board should respect the rights of shareholders, and foster constructive relationships with shareholders and stakeholders that encourage them to engage with the entity.

Guidelines

We encourage entities to:

8.1 Publish clear policies for shareholder relations to the extent relevant to their shareholding structure. Policies should clearly communicate the goals, strategies and performance of the entity. Such policies should include a regular review of practices.

8.2 Publish up-to-date information, online or in another easy-to-access format, providing:

- a comprehensive description of its business and structure
- commentary on its goals, strategies and performance
- key corporate governance documents
- separate information that shows how it has followed the principles in this handbook (if not in the annual report).

8.3 Encourage shareholders to take part in annual and special meetings. Shareholders will be more inclined to attend meetings if they are easy for them to get to and held at a convenient time. Information about the meetings' agendas should be clear and meaningful to shareholders.

8.4 Recognise it is in shareholders' interests to take account of the interests of other stakeholders, (eg customers, employees, the public, the government, and anyone else affected by the business).

8.5 Take account of stakeholder interests by, for example:

- having clear policies for the entity's relationships with significant stakeholders, bearing in mind distinctions between public, private and Crown ownership
- regularly assess compliance with these policies to ensure conduct towards stakeholders complies with its code of ethics and the law
- check conduct towards stakeholders aligns with current accepted social, environmental, and ethical norms.

FMA commentary

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

The role of shareholders in corporate governance

As owners, shareholders have important rights and functions in corporate governance. Certain matters are reserved for shareholder approval and boards can facilitate appropriate shareholder involvement. If relations with shareholders are cooperative, entities will be better placed to attract the capital and support they need, and to demonstrate real accountability.

Good governance requires effective communication between an entity and its shareholders. A policy for communicating with shareholders and encouraging shareholder participation can assist. This can include:

- being responsive to shareholders' questions and ways to make information more accessible to shareholders and others
- giving shareholders sufficient time and detail to participate in decisions
- clearly setting out resolutions for shareholder decisions, and encouraging informed use of proxies
- providing ready access to auditors for shareholder questions at annual and special meetings
- allocating time and resources to providing clear, plain-language explanations of performance, strategies and goals, and identified material risks in their annual report and (if applicable) half-year reports
- actively maintaining websites with:
  - comprehensive, up-to-date information about operations and structures
  - key corporate governance documents
  - shareholder reports
  - current and past announcements
  - performance data.

Institutional shareholders play a vital role in monitoring company performance. Those with voting power in an entity need to make use of their rights to question and challenge the board's performance and corporate governance practices. Boards can increase accountability by encouraging all shareholders to vote on resolutions.

Stakeholder interests in corporate governance

An entity's business activities can impact a wide range of stakeholders. This could include: employees, customers, creditors, suppliers, and the wider community. Legal obligations and relevant social, ethical, and environmental factors need to be taken into account when considering the interests of stakeholders.

Good corporate governance and benefits to stakeholders

Company law requires directors to act in the best interests of the company (subject to certain exceptions). Advancing the interests of other stakeholders, such as employees and customers, will often further the interests of an entity and its shareholders.

Good corporate governance practices will benefit stakeholders and shareholders. Relationships with significant stakeholders can be improved if addressed in specific policies that are disclosed and reported to stakeholders. Managing stakeholder interests should be viewed as good business and can have positive long-term impacts on society and the environment. It ensures entities maintain their social licence to operate.

Stakeholder interests in public-sector entities

Stakeholder interests are particularly significant for public-sector entities. As they receive government funding, they need to pay careful attention to their public stakeholders.

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

AUCKLAND

Level 5, Ernst & Young Building
2 Takutai Square, Britomart
PO Box 106 672, Auckland 1143

Phone: +64 9 300 0400 Fax: +64 9 300 0499

WELLINGTON

Level 2, 1 Grey Street
PO Box 1179, Wellington 6140

Phone: +64 4 472 9830 Fax: +64 4 472 8076