Consultation Paper: FMA Corporate Governance handbook

About this consultation paper

The FMA last updated the Corporate Governance Handbook in 2014, providing advice for listed and unlisted companies.

Earlier this year, the NZX published an updated corporate governance code (NZX Code) for companies listed on the NZX's markets. The NZX Code was closely based on the principles in our 2014 handbook. We now view the updated NZX Code as the primary guidance on corporate governance practices for companies listed on NZX's markets.

In this refresh of the handbook we have moved our focus away from listed companies, while ensuring directors and executives of New Zealand-based companies and entities continue to have a practical guide for applying corporate governance principles to a variety of sizes and types of business. We have also updated the guidance to ensure we are aligned with developments in corporate governance since the handbook was first published. These are outlined in the introduction to the handbook and include non-financial reporting, directors and executive remuneration and auditors.

Our proposed changes remove references to listed companies from the handbook and we encourage all listed companies to refer to the NZX Code for corporate governance obligations. We will continue to engage with the NZX and listed companies to ensure standards of corporate governance practice for listed companies continue to rise.

The principles in the handbook do not impose new legal obligations. They do, however, set out standards for corporate governance practice we believe directors and executives should apply and report on to their investors, shareholders and stakeholders. We want to see entities explaining how they comply with each principle.

We welcome feedback on the draft handbook – its intent, its content and how it is presented. Please use the feedback form at the back for any comments.

Submissions close on 8 December 2017.

Next steps

After we have considered submissions, we will finalise the handbook and publish it in early 2018.

Who needs to read this consultation paper:

This consultation is for the directors, executives and advisers of non-listed and public-sector companies and other entities	We seek feedback about whether our revised handbook helps directors, executives and advisers to think about how to apply corporate governance principles.

Questions

Questions	
Question 1	Do you agree with our overall approach to move our focus away from listed issuers?
Question 2	Is more guidance needed for companies seeking to grow and possibly raise capital and/or list in the future - if yes, in what areas would guidance be useful (please give examples of the additional guidance you think should be added)?
Question 3	Do you have any feedback on the structure or presentation of the document? Is there anything we could improve about the way it has been written, or communicated, to better assist directors and executives to apply the corporate governance principles?
Question 4	In most areas we have made very few changes to the substantive guidance. Are there any specific areas where we should include more guidance or commentary?
Question 5	Are there any areas where we are out of step with guidelines that your Company/Board follows, or any other areas of ambiguity in the handbook?
Question 6	Are there any cost implications or other barriers to adopting the revised guidelines?

Feedback form

Feedback: FMA Corporate Governance handbook

Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with '**Feedback: FMA Corporate Governance handbook**' and your entity name in the subject line. Thank you. **Submissions close on Friday, 8 December 2017.**

Date: Number of pages:

Name of submitter:

Company or entity:

Organisation type:

Contact name (if different): Contact email and Phone:

Question number:	Response
You don't need to quote from the consultation document if you note the paragraph or question number.	
Q1	
Q2	
Q3	
Q4	
Q5	
Q6	

Feedback summary – *if you wish to highlight anything in particular*

Please note: Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.

Thank you for your feedback – we appreciate your time and input.

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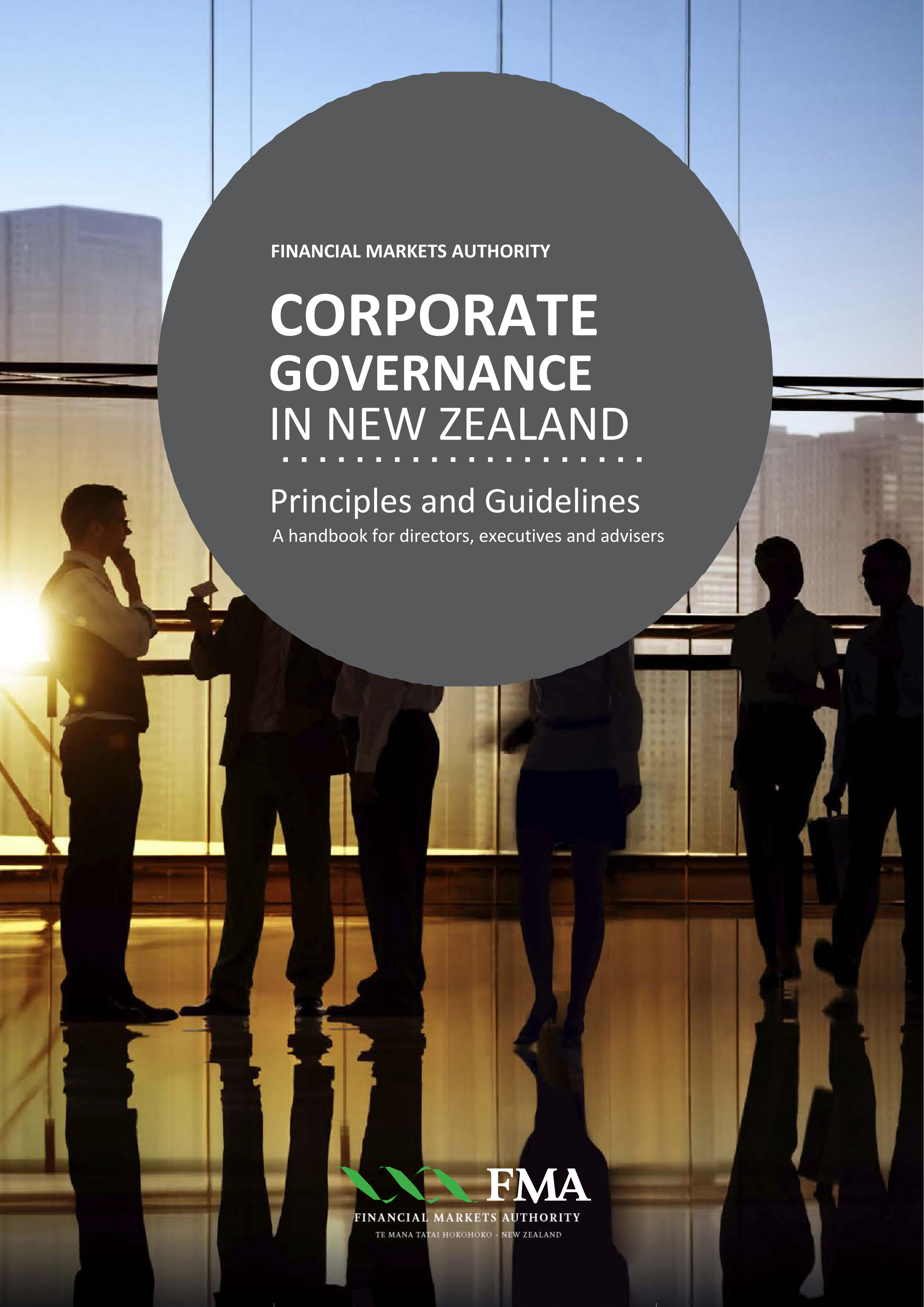

FINANCIAL MARKETS AUTHORITY

CORPORATE GOVERNANCE IN NEW ZEALAND

Principles and Guidelines

A handbook for directors, executives and advisers

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

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Corporate Governance in New Zealand: Principles and Guidelines
2017

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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 is the principles, practices and processes that determine how a company or other entity is directed and controlled. Good corporate governance supports investor confidence. It is key 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.

Corporate governance for any entity will depend on the nature and purpose of its business, operating environment and stakeholders. This handbook is 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 the corporate governance principles. Establishing good corporate governance means directors and executives can focus on growth, value-creation and long-term sustainability.

Who should read this handbook?

Broadly, the principles apply to companies and entities with an economic impact in New Zealand. Or to companies and entities which, because of their involvement in our financial markets, are accountable to the New Zealand public. This includes:

- 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
- other companies.

Refining our focus

We updated this handbook in 2014 and 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. The NZX Code was based on our 2014 handbook. We now view the updated NZX Code as the primary guidance on corporate governance practices for companies listed on the NZX's markets. We will continue to engage with the NZX and listed companies to ensure standards of corporate governance practice for listed companies continues to rise. We will also continue to take appropriate action where we find examples of poor governance.

We have decided to refocus our handbook to non-listed companies and to directors and executives of a broader range of companies and entities, many of which have a significant impact on New Zealand's financial markets. It's important that their directors and executives continue to have a practical guide for applying corporate governance principles to a variety of sizes and types of business.

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 also be useful for these groups as they consider their governance frameworks against the obligations.

Our approach

Principles

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

The principles are not in any 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. We focus on principles rather than using a checklist or rules. A 'one-size-fits-all' approach is not appropriate for the range of companies and entities this handbook applies to.

Not all principles will wholly apply to all companies and entities. Directors and executives should consider the nature and needs of their businesses when they consider whether each principle is relevant 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. But 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.

Given the high-level nature of the principles, we ask boards to explain how they comply with each principle. We do not use the 'comply or explain why not' approach of the NZX Code. That approach is appropriate for the NZX Code, but we believe the 'explain' approach of this handbook allows the greater flexibility necessary for reporting by the broader range of companies and entities this handbook applies to.

Guidelines and commentary

As in the NZX Code, our handbook also provides guidelines and commentary for each principle.

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.

Commentary provides context and other information that may assist directors and executives to understand why a particular principle is important to apply.

Other useful references

Directors of companies can refer to the *Institute of Director's (IoD's) Code of Practice* for Directors, which should be read together with its publication, *The Four Pillars of Governance Best Practice*. These publications contain high level principles of governance best practice plus practical guidance on day-to-day directorship.

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 to assess whether going public is appropriate for their company or entity. It also provides insight into the process of becoming a public company.

Holders of market services licences under the FMC Act may refer to our *Guide to the FMA's view of good conduct* for further useful commentary on governance for FMC Act-licensed entities.

Changes in this revised version – quick reference

We have updated the following subject matter under the principles:

Principle 3: Board committees

External audit firms and association with the chairperson.

Principle 4: Reporting and disclosure

Non-financial reporting.

Principle 5: Remuneration

Transparency of long and short-term incentives.

Principle 6: Risk Management

Risk management and environmental, social and governance (ESG) matters.

Principle 7: Auditors

Standards of best practice for appointing auditors, non-audit work and independence.

Principle 9: Stakeholder interests

To maintain alignment with the NZX Code, we have *removed* Principle 9 (Stakeholder interests). Stakeholder considerations are important, so they have been incorporated into all eight principles (in particular Principle 4 on reporting and disclosure, and Principle 8 on shareholder relations). We have also updated our commentary.

How to report against the principles

All companies and entities should report how they apply the principles

Good corporate governance relies on transparency. Implementing the principles therefore includes reporting on corporate governance practices to shareholders and other stakeholders. For most companies and entities this can be achieved in the annual report, or through links to online content – company websites should have strong, easily accessible corporate governance sections. We encourage companies to take a continuous approach to keeping their information current across the year and to update key information and disclosures when things change.

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 it has used them.

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

Directors should consider their own, and the company's, performance against each of the principles before information is prepared. The principles should be 'owned' by the board, and not delegated to management as a 'tick box' compliance effort.

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

Formal corporate governance reporting may be new to some smaller unlisted entities. All entities should think about their corporate governance practices. Some smaller entities may decide that only some of the principles apply. And it may take time for some smaller entities to implement and report against the principles. In the meantime, we think it would be helpful for smaller entities to report to their investors and stakeholders on progress made towards observing and reporting on each principle.

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.

Principles and guidelines

Guidelines

- The board of an entity should adopt a written code of ethics that is a meaningful statement of its core values. The code should set out explicit expectations for ethical decision making and personal behaviour covering, at a minimum:
  - acting honestly and with high standards of personal and professional integrity
  - 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 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, including insider trading in the entity's securities
  - fair dealing with customers, shareholders, clients, employees, suppliers, competitors and other stakeholders
  - giving and receiving gifts, koha, facilitation payments and bribes
  - compliance with applicable laws and regulations
  - reporting unethical decision-making and/or behaviour
  - conduct expected of management and the board for responding to and supporting whistleblowing.
- The code of ethics should include processes for recording and evaluating compliance with the code and for dealing with breaches.
- The entity should communicate its code of ethics to its employees and support their compliance with training and clear procedures
- The entity should also publish its code of ethics and report on steps taken to implement and monitor compliance with the code. Reporting should include action taken on serious breaches.
- The 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 acting ethically at all times.

FMA commentary

Ethical behaviour is central to all aspects of good corporate governance. Good governance structures encourage high standards of ethical and responsible behaviour, but can only be effective when directors and boards are also committed to these same standards.

The benefits of a code of ethics

For companies widespread adoption and implementation of codes of ethics will help promote public confidence in governance structures and behaviour.

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 should be included. As circumstances change, codes of ethics should be reviewed, expanded or updated to ensure they remain relevant.

A code of ethics will not create ethical and responsible practices. It is simply a guide and reminder of expected behaviour, and sets 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 need to monitor its effectiveness. This could form part of the board's annual performance assessment.

Ultimately the board is responsible for ethical behaviour within the entity. Larger boards could consider convening an ethics committee to assess the performance of directors against the code of ethics. We also encourage entities to seek independent verification, on a periodic basis, of the code's implementation and effectiveness.

Transparency encourages ethical behaviour by increasing accountability. This will be enhanced if codes of ethics are published alongside meaningful information that reports on the steps taken to implement the code and monitor compliance. This reporting should include, in general terms, information about any serious instances of unethical behaviour within the entity, and the steps taken to deal with this.

Principle 2: Board composition and performance

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

Guidelines

- Directors should be selected and appointed through rigorous, formal processes designed to give the board a range of relevant skills and experience.
- 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'.
- All directors should, except as permitted by law and disclosed to shareholders, act in the best interests of the entity.
- The board should have a formal charter setting out the responsibilities and roles of the board and directors, including formal delegations to management.
- The chairperson should be formally responsible for fostering a constructive governance culture and applying appropriate governance principles among directors and with management.
- We recommended the chairperson should be independent. No director of an entity should simultaneously be a board member, chairperson and chief executive (or equivalent). Only in exceptional circumstances should the chief executive go on to become the chairperson.
- The board should be satisfied a director will commit the time needed to be fully effective in their role.
- The board should set out in writing its specific expectations of non-executive directors (including independents).
- The board should allocate time and resources to encouraging directors to acquire and retain a sound understanding of their responsibilities. This should include appropriate induction for new appointees and on-going training for all directors.
- The board should have rigorous, formal processes for evaluating its performance, and that of board committees and individual directors, including the chairperson. This could extend to formally reviewing the position of chairperson on a regular basis.
- Reporting should include information about each director, including a profile of experience, length of service, independence and ownership interests in the company. Information on the board's appointment, training and evaluation processes should also be included.

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 affairs of the entity. Individual directors may bring particular attributes that complement other directors.

An effective board requires its members to have range and balance of relevant attributes. This will include gender, ethnicity, cultural background, age and specific skills.

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

Independence of mind is a basic requirement for directors. Each director should endeavour to have an independent perspective when making judgments 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—increasing the board's effectiveness.

Non-executive directors and independence

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. We encourage entities to establish and publish clear criteria for defining independent directors.

Independent representation should be considered along with the other attributes needed in a non-executive director. Formal independence is not an asset if it does not come with independence of mind, and an appropriate contribution of skills, knowledge, experience and time.

Factors influencing independence

There may be practical constraints in New Zealand if too high a level of formal independence is required. However, the independence of directors is something that investors should have confidence in. We consider the underlying issues related to director independence can be addressed by:

- directors having an independent perspective when making decisions
- a non-executive director being formally classified as independent only where he or she does not represent a substantial shareholder or other key stakeholder, and the board is satisfied he or she has no other direct or indirect interest or relationship that could reasonably influence their judgment and decision-making
- the chairperson of an entity being independent

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

Other factors that may impact director's independence are:

- recent employment in an executive capacity by the entity or any of its subsidiaries
- having held a recent 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 (e.g. supplier or customer) with the entity or any of its subsidiaries
- having close family ties with any person who falls within the above categories
- having been a director of the entity for such a period that the director's independence may have been compromised.

Boards of companies that intend to raise capital and/or list in the future, or are otherwise perceived to be publicly accountable due to their role in the financial markets, are encouraged to either have, or building towards:

- a majority of non-executive directors
- a minimum one-third of independent directors.

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

Tenure

We encourage boards to consider the length of service of each of their directors and the impact this has on their ability to remain independent. Regular review of the length of board appointments will also improve the board's ability to strike the right balance between institutional knowledge and fresh thinking.

It will also ensure the board has the right mix of skills for the stage and needs of the company. This should an integral part of its succession planning.

Roles and responsibilities for the board and executives

Efficiency and accountability are improved if the respective roles of the board and executives are well understood by everyone. A board charter can be helpful that sets out the responsibilities of the board and its directors, and includes details of any delegations given by the board to management. Directors are entitled to seek independent advice. This may be necessary to be fully informed 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 should lead the process of evaluation and review of the board's performance. The chairperson also has a pivotal role between the CEO and the board. The balance between these roles is important, and works best if the roles of chairperson and chief executive (or equivalent) are clearly separated, and the chairperson is an independent director. In general, the chief executive should not become chairperson. Only in special circumstances should the roles be combined, for example where an individual has skills, knowledge and experience not otherwise available to the entity (and where these circumstances are fully explained to investors and stakeholders).

Nomination committees

The optimum number of directors depends on its size, the nature and complexity of its activities, as well as its requirement for independent directors. Too large and decision-making becomes unwieldy; 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 this task, as well as on tenure and succession planning.

Being an effective board member

It is important that non-executive directors clearly understand their expected roles and responsibilities, especially if they do not have prior knowledge of an entity. Induction, professional education and a written statement of expectations for each non-executive role, including the expected time commitment, can assist.

Principle 3: Board committees

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

Guidelines

- The 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 entire board.
- Where boards have board committees, the charter and membership of each should be easily accessed on the company's website.
- Proceedings of committees should be reported back to the board to allow other directors to question committee members.
- For larger entities, it may be appropriate to establish an audit committee of the board with responsibilities to recommend the appointment of external auditors; oversee all aspects of the entity-audit firm relationship; and to promote integrity and transparency in financial reporting.

Audit committees should comprise, where possible:

- 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; and
- a chairperson who is independent and not the chairperson of the board.

The chairperson of the audit committee should not have a long-standing association with the external audit firm as either a current or retired audit partner or senior manager within the firm.

FMA commentary

Board committees may not be appropriate or practical for all entities. However, in larger or more complex businesses, board committees can significantly enhance effectiveness through 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 and the extent of any formal delegations from the board.

The accountability of the entire board should be maintained, including the work of committees. The board should be well informed about decisions for which it retains ultimate responsibility. Committee proceedings should be reported back to the board. Directors who are not on the committee should be given time to comment on, or seek an explanation of, the committee's business.

The role of an audit committee

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

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

As with other committees, the audit committee's role should 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 and transparency of the entity's financial reporting.

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 the use of committees and particular consideration should be given to appointing a risk committee.

Principle 2 commentary includes information on 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 boards give proper time and attention to these matters and committee decisions are robust and transparent. Entities, particularly those with large boards, should carefully consider whether the use of committees could enhance their effectiveness in these key areas.

Principle 4: Reporting and disclosure

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

Guidelines

- Boards should have a rigorous process to ensure the quality and integrity of financial statements and non-financial reporting including their relevance, faithful representation, verifiability, comparability and timeliness.
- 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. Financial statements are complex and can be challenging for readers. We encourage boards to aim for financial reports that are clear, concise and effective, while meeting the requirements of financial reporting standards.
- Boards should determine the appropriate level of non-financial reporting, considering the interests of their stakeholders and all relevant environmental, social and governance (ESG) factors.
- All boards must maintain an effective system of internal control for reliable financial reporting and accounting records.
- The directors should explain in the annual report their responsibility for preparing the annual report, including the financial statements that comply with generally accepted accounting practice.
- Where appropriate, an entity should make its code of ethics, board committee charters, any ESG reporting and other governance documents readily available to interested investors and stakeholders. This information should be available on the entity's website. Public sector entities should 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 a principal incentive for good corporate governance. Reporting and disclosure encompasses both financial and non-financial reporting.

Responsibility for financial reporting

The quality and integrity of financial reports are reflected in how easy they are for users to understand. Legal and regulatory requirements, 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 quality and accuracy of financial reports. This requires company records to be complete and accurate by adopting appropriate accounting policies and implementing appropriate controls and processes. The audit committee (Principle 3) and independent auditors (Principle 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, who have ultimate responsibility for financial reports. Executives' accountability is further strengthened by the CEO and CFO certifying the published financial statements. Directors retain liability for the financial statements of an entity. 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.

Reporting and disclosure requirements are particularly important for public sector entities, for issuers and for entities providing financial services. 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 the users of their financial reports. Non-listed entities that have raised money from the public should report to investors on the entity's goals, strategies, position and performance.

ESG reporting

Over and above their commercial and economic objectives, entities are encouraged to disclose policies and performance relating to environmental, social and governance (ESG) issues. Where appropriate, entities are encouraged to report on environmental issues, business ethics, human rights, and other public policy commitments. Such non-financial reporting is important for investors and other stakeholders to better assess the relationship between companies and the communities which are impacted by their operations. This is because ESG factors, while typically classified as non-financial, eventually have a financial impact through increasing costs or threatening an entity's 'licence to operate'. Reporting of ESG factors, and how an entity identifies and manages them, allows for a more comprehensive understanding of an entity's overall performance, and related risks and opportunities. Entities can adopt a formal framework to report on ESG factors such as the Global Reporting Initiative guidelines or the International Integrated Reporting Framework. Where it is not practical for entities to adopt a formal ESG framework, they could instead select specific non-financial matters to report on. Either way, 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.

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Guideline

- The board should have a clear policy for setting executive remuneration, including executive directors and non-executive directors. Remuneration should be fair and reasonable in a competitive market for the skills, knowledge and experience required
- Entities with wide shareholdings should disclose their remuneration policies to shareholders
- Executive (including executive director) remuneration should be clearly differentiated from non-executive director remuneration.
- Executive (including executive director) remuneration packages should 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.

Establishing appropriate remuneration is particularly complex and each entity’s context is critical. Every board should have policies and processes for setting remuneration and for remuneration reporting (including disclosures required under the Companies Act 1993).

Shareholders want to see remuneration policy attracts the right directors, and remuneration is reasonable. To enable shareholders to assess this, the policy for determining remuneration should be disclosed, as well as the total remuneration and a full breakdown of any other benefits and incentives paid to directors. This breakdown should include short-term and long-term term incentives.

Remuneration for 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 a component 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. To ensure accountability, all benefits received should be disclosed to shareholders.

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

Principle 6: Risk management

Directors should have a sound understanding of the key risks faced by the business. The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.

Guidelines

- The board should require the entity to have rigorous processes for risk management and internal controls.
- The board should receive and review regular reports on the operation of the risk management framework and internal control processes, including any developments in relation to key risks.
- Reports should include oversight of the company's risk register, and highlight the main risks to the company's performance and the steps being taken to manage these.
- Boards of issuers should report at least annually to investors and stakeholders on risk identification, risk management and relevant internal controls.

FMA commentary

Taking appropriate risk is an essential feature of business. Each entity is faced with a range of risks that it needs to identify and choose to manage (or avoid). Risk management is a critical responsibility for boards. To be effective, boards must be aware of, and be able to properly assess, the nature and magnitude of risks faced by the entity.

Processes to manage risk

Enterprise-wide risk management frameworks (and others) are useful to identify, monitor and manage risks, which vary across entities. Companies globally and in New Zealand are facing increasing calls to consider ESG matters in their identification and management of risk. These calls have, in part, been driven by rising expectations from investors for higher levels of transparency of risks faced by entities they invest in. More transparency allows investors to better assess risks to their capital. We recommend entities consider ESG matters as part of their risk assessment – and report on what risks are relevant, and how they manage or intend to manage them. Entities may wish to adopt a formal ESG framework (as outlined in Principle 4) or engage in other forms of reporting.

We also encourage entities to develop and maintain a risk register to identify the key risks, record the likelihood and impact of each risk, and highlight the steps taken to mitigate each risk. This enables the board and managers to be properly informed and implement internal control systems that are responsive to the any existing risks or emerging risks.

These processes will usually operate alongside other internal control structures, depending on the size and circumstances of the entity. A separate risk management function or committee may be appropriate.

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

Entities should report at least annually to investors on their risk management. Reports should detail how the board effectively oversees risk and how key risks are managed. The commentary in Principle 3 includes information about the benefits of having a separate risk committee.

Principle 7: Auditors

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

Guidelines

- The board should fully inform itself on the responsibilities of external auditors and be rigorous in its selection of auditors on the basis of professional merit.
- The board should satisfy itself there is no relationship between the auditor and the entity, or any related person that could compromise the auditor's independence.
- The board should facilitate regular and full dialogue among its audit committee, external auditors and management.
- No issuer's audit should be led by the same audit partner for more than seven consecutive years.
- Boards of issuers and entities obliged to prepare and file financial reports under the FMC Act should report annually to shareholders and stakeholders on the fees paid to auditors. This report should differentiate between audit fees and fees for individually identified non-audit work (for example, separating each category of non-audit work undertaken by the audit firm, and disclosing the fees for this).
- Boards should approve audit fees, and any other services provided by their auditor, and should not delegate this function to management.
- Boards of issuers should explain in the annual report what non-audit work was undertaken and why this did not compromise auditor objectivity and independence. They should also explain:
    - how they satisfy themselves on auditor quality and effectiveness
    - the board's approach to tenure and reappointment of auditors
    - any identified threats to auditor independence
    - how the threats have been mitigated.

FMA commentary

The quality of 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 the financial reporting processes.

The board and the 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, and facilitate access to information and personnel.

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 engage with auditors to ensure there is a common understanding about the scope of audit engagements and the evidence auditors will expect to be able to find when testing judgments applied to financial statements.

When selecting auditors, boards should ask whether they have been quality reviewed by the FMA, and if so, whether any issues have been identified and what steps the firm has taken to address these.

Rotation of auditors is important to ensure independence and objectivity over time. This needs to be balanced against the costs that are necessarily incurred when a new auditor is engaged.

Costs of a new auditor are necessarily higher until the auditor becomes familiar with the entity and its business. Retaining a degree of 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. This will help balance cost, efficiency and independence.

Non-audit work

Limiting non-audit work done by an audit firm helps 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 audit firm should not undertake any work for an audit client that 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 be likely to conclude regarding the audit firm's independence.

The fees paid for non-audit work will be a factor in determining independence. Non-audit services often create self-review threats for the auditor. The audit committee should consider whether these threats are sufficiently mitigated. Using different teams within the same audit firm to perform these services will not always sufficiently mitigate the threats.

Issuers should focus on improving the disclosure in financial statements regarding non-audit work, to ensure investors can get an informed view of the auditor's independence. Further, the audit committee should provide feedback to the full board regarding auditor independence. Feedback should cover non-audit work and other threats to the independence of their auditor.

Auditor independence

Auditor independence is crucial for investors, who rely heavily on this external assurance. Boards are accountable to investors where they allow auditors to undertake non-audit work. This accountability can be achieved by including a statement as to why, in the board's opinion, any non-audit work or other threats to independence, such as a long association between a member of the audit committee and the audit firm, do not impinge on the independence of the auditor. This statement can be included in the company's annual report and should be accompanied by disclosure of all fees paid to the auditor, with various types of non-audit work separately identified, using professional standards.

Dealing with complaints

The audit committee has a crucial role if complaints arise in the auditor-client relationship, or any other aspect of auditing. The committee should have a process for dealing with complaints from auditors, such as complaints about 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, 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.

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 so shareholders can ask questions.

Principle 8: Shareholder relations and stakeholder interests

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

Guidelines

We encourage entities to:

- Have clear published policies for shareholder relations to the extent relevant to their shareholding structure. Policies should be focused on clear communication of goals, strategies and performance of the entity. The policy should include regular review of its practices.
- Maintain an up-to-date website, providing:
  - a comprehensive description of its business and structure
  - commentary on goals, strategies and performance
  - key corporate governance documents
  - if not included in its annual report, a separate section that reports against the entity's adherence to these principles.
- Encourage shareholders to take part in annual and special meetings by holding these at locations and times convenient to shareholders. Information about the business to be conducted at the meetings should be clear and meaningful.
- Recognise that it is in shareholders' interests to take account of the interests of other stakeholders, such as customers, employees, the public, the government, and anyone affected by the business. This can be reflected by the board (for example):
  - having clear policies for the entity's relationships with significant stakeholders, bearing in mind distinctions between public, private and Crown ownership.
  - regularly assessing compliance with these policies to ensure conduct towards stakeholders complies with its code of ethics and the law, and is within broadly accepted social, environmental, and ethical norms.

FMA commentary

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 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. Entities will be better placed to attract the capital and support they need, and to demonstrate real accountability, if relations with their shareholders are cooperative.

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

- being more responsive to questions from shareholders and making 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 the annual and (for listed entities) half-year reports
- actively maintaining websites with comprehensive, up-to-date information about their operations and structures, key corporate governance documents, shareholder reports, current and past announcements and performance data.

Institutional shareholders have a vital role to play in monitoring company performance. For disclosure about maintaining corporate governance standards 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 corporate governance practices. Boards can increase accountability by encouraging all shareholders to vote on resolutions.

Stakeholder interests in corporate governance

A company's business activities can impact on a wide range of stakeholders, such as employees, customers, creditors, suppliers, and the 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 they are addressed in specific policies that are disclosed and reported to stakeholders. Managing stakeholder interests should be viewed as simply good business – and can have positive longer term impacts on society and the environment. This ensures businesses maintain their social licence to operate.

Stakeholder interests in public-sector entities

Stakeholder interests have a particular significance for public-sector entities. These entities operate on public funding, and need to pay careful attention to their public stakeholders