



Institute of
CHARTERED ACCOUNTANTS

of New Zealand

SUBMISSION TO THE

SECURITIES COMMISSION

CORPORATE GOVERNANCE PRINCIPLES

Prepared by
the Institute of Chartered Accountants of New Zealand

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I: EXECUTIVE SUMMARY AND RECOMMENDATIONS

1. Governance is important. It is a significant driver of economic growth, and determinant of the quality of government spending and regulation. Governance can make the difference between whether a company succeeds or fails, and can determine whether a public entity delivers on the government's objectives and meets public expectations for acceptable standards of conduct.
2. Comparatively, governance in New Zealand, in both the public and the private sectors, is good.
3. For the most part, shareholders and other market participants drive the quality of corporate governance in the private sector. Disciplines from the threat of company failure, take-over and changing share values force companies to continually seek improvement to their governance practices. Market disciplines are complemented by the provisions of the Companies Act and other business law provisions and, for more serious transgressions, by the Crimes Act.
4. Reform should not be rushed. Legislation is coercive and costly, and must be designed and applied with a skilful hand if it is to serve New Zealand's overall interests. Poorly conceived regulation increases the cost of business, reduces consumer choice and reduces innovation. The social costs can be significant. For political and operational reasons, poor regulation is not easily reversed.
5. In considering reform options, a frequently discussed theme is the need to follow overseas regulatory developments. The Institute cautions against this approach, concluding that New Zealand's interests are best served by it being a discerning consumer of overseas regulation.
6. To enhance current disciplines for good corporate governance, the Institute proposes that legislation be amended to require public issuers to report against corporate governance principles, or objectives. These objectives should be underpinned by guidance to:
 - Explain what the corporate governance objectives are;
 - Identify barriers and opportunities to achieving those objectives; and
 - Provide examples of good practices.
7. The same disciplines on the private sector to have in place good corporate governance are absent in the public sector. It is the public sector where the greatest gains are possible, and where the government should focus its efforts. The Institute has suggested a number of options for further consideration. In doing so, we note that approaches appropriate to the private sector are unlikely to work well in the public sector.
8. Finally, the Institute identifies a number of risks to the Securities Commission being able to obtain information through its questionnaire that will serve as a solid base for government decision making. At the least, the Institute strongly

recommends that government consult on options for improving corporate governance before taking final decisions.

II: INTRODUCTION

9. The Institute welcomes the opportunity to provide its views to the Securities Commission on its questionnaire, “Corporate Governance in New Zealand, Consultation on Issues and Principles”.
10. Part III of this report provides background comment on the Institute’s process that led to the Securities Commission’s review of corporate governance. Part IV provides general comment on the recent United States reporting failures, including the market and government responses to those failures, and the New Zealand government and non-government factors that make up New Zealand’s corporate governance environment.
11. Part V outlines the Institute’s preferred approach to promoting corporate governance in New Zealand. This option follows closely that outlined by the Institute’s working group on corporate reporting. The working group produced the report “Improving Corporate reporting: A Shared Responsibility” for the Minister of Commerce in May this year.
12. At a recent meeting with the Minister of Commerce, the Hon Lianne Dalziel, it was confirmed that submitters should not feel constrained to respond only to the questions posed by the Commission, and that comments on approaches for achieving good corporate governance outcomes in New Zealand would be welcomed. We have taken this approach.
13. Part VI briefly outlines and comments on alternative regulatory options. At the meeting with the Minister of Commerce the Minister confirmed that regulation was a possible outcome of the Commission’s review, and for that reason we discuss regulatory options.
14. Part VII comments on the merit of New Zealand adopting overseas regulation as a means of promoting market confidence and attracting investment from overseas.
15. Part VIII is the only part of the report to address public sector governance. While welcoming the Commission extending the governance debate to public sector entities, the Institute considers public sector and private sector governance to be appreciably different.
16. Part IX provides the Institute’s replies to the Commission’s questions we feel it appropriate for the Institute to comment on. In answering many of these questions, we have drawn heavily from the report “Improving Corporate Reporting: A Shared Responsibility”.

17. Finally, Part X outlines what the Institute believes to be the main risks to the Commission deriving information that will be of most value to government decision makers.

III: BACKGROUND

18. In early 2002 the Institute undertook a project to review the extent to which New Zealand was at risk of the type and prevalence of reporting failures being experience in the United States. Issues of corporate governance were central to that review.
19. In undertaking that work, the Institute also set itself the task of making recommendations where the Institute considered New Zealand could, at reasonable cost, improve corporate reporting. A final report, prepared by the Institute's working group on corporate governance, was provided to the Minister of Commerce in early May 2003.
20. The final report "Improving Corporate Reporting: A Shared Responsibility", did not find evidence of significant risk of fraud and reporting failure in New Zealand. For example, our equity markets have been spared the "irrational exuberance" that has characterised the United States markets over much of the last ten years.
21. That said, we believe it important that New Zealand's markets not become complacent. The Institute's working group identified, amongst its 22 recommendations, a number of things that could and should be done to reduce opportunities for fraud and financial reporting related failures in New Zealand, including adopting professional standards on, among other things:
 - Employment of audit staff by the audit client, and vice versa;
 - Non-audit services provided by the auditor to its audit clients;
 - An audit firm or audit partner working on the same client for long periods of time; and
 - The level of fees that can be taken by an audit firm from one client.
22. These issues have now been taken up by the Institute and approved for inclusion in the Institute's Code of Ethics.
23. Other of the working group's recommendations, including a review of penalties and enforcement, auditor liability and a review of public issuer reporting have been taken up by government and are being considered by officials before being reported back to Ministers.
24. The working group also recommended that public issuers be required to report against key corporate governance principles, or objectives. The OECD principles on corporate governance were used as a starting point. These objectives would be underpinned by guidance to:
 - Explain what the corporate governance objectives are;
 - Identify barriers and opportunities to achieving those objectives; and

- Provide examples of good practices.
25. The Minister of Commerce asked the Securities Commission to take this work forward. In doing so, the Commission has broadened the project to include public entities, and entities other than just public issuers (the Institute working group, while commenting that its recommendations could have wider application, focussed on public issuers only).

IV: GENERAL COMMENTS

The United States Reporting Failures

26. Business failure in itself is not a reason for government action, being the natural consequence of firms competing to best meet consumer needs on cost and quality. It is desirable that firms that perform this task relatively poorly fail, thereby freeing up scarce resources to more successful firms. Overall, this is good for consumers, employees and shareholders. Further, it is not surprising that, at the end of the most sustained bull run in United States history, the number of failures should be comparatively larger, or that those failures should include amongst their ranks businesses of substantive size.
27. That said, some of the failures have highlighted serious deficiencies in corporate governance. In particular, for some of the corporates it has highlighted a breakdown in key accountability relationships within the corporate, between the corporate and its Board, and between the corporate and its investors. This breakdown occurred within an environment of failure at many levels, including cursory external auditing, ineffectual regulators, indiscriminate financial advisors and complacent investors. The Institute considers the primary contributor to these failures was systemic overconfidence and complacency.
28. This breakdown allowed two things to happen, it provided greater opportunities for fraud, and it created an environment which allowed for poor quality decision making. While fraud perhaps made the headlines more than did poor quality decisions, it is clearly the latter that contributed more to corporate failure and the substantive losses in shareholder value.

The Market Response

29. The response of markets to these failures has been swift and far reaching, more so than regulators could ever hope to match. Legal writs against transgressors were filed, Arthur Anderson was deserted by clients and creditors alike before quickly folding, corporates with effusive reporting or suspect practices were heavily punished by investors, insurance premiums for professional indemnity insurance soared and professional advisors including rating agencies revised their strategies. Not all the change was good, with the rush out of equities being less discriminatory than was perhaps fair, and some overreaction was evident as boards moved out of “wealth creation and retention” mode and into “compliance mode”.

The Regulatory Response

30. Government also responded quickly. The Securities and Exchanges Commission, in particular, became more aggressive in routing out wrongdoing. Congress voted it a significant increase in funding. The Sarbanes-Oxley Act was passed, bringing into law many prescriptive and punitive measures. Auditing became subject to greater government control.
31. In pursuit of restoring market confidence, much of the regulation in the United States appears to be “punishing” the markets rather than addressing market problems. This may not prove to be in the best interests of customers, shareholders, and employees. The high price earnings ratios for equities (currently around 30, compared with a historical average of approximately 12-15) suggest that the market does not lack confidence. It is possible to argue the government has been too successful at promoting confidence, while failing to address real market problems. This approach risks positioning the market to fail again.

New Zealand

32. In New Zealand, the government complements the market in promoting corporate governance through, for example, the Companies Act 1993, the Securities Act 1978, and for more extreme behaviour, the Crimes Act 1961. Standards are enforced through the Registrar of Companies, the Securities Commission, the Serious Fraud Office, the Police and other government agencies. In addition, professional bodies such as the Institute and the Law Society enforce their own governance standards on members. Finally, common law and the courts operate to allow private action to enforce standards of corporate governance.
33. The Institute considers market disciplines, supplemented by existing government and non-government interventions, to provide a sound base for achieving a level of corporate governance consistent with meeting the needs of investors, corporates, customers and employees.
34. That said, the Institute sees some room for improvement, in particular in the area of disclosure.

V: PREFERRED OPTION

The Problem

35. Any agency relationship, such as that that exists between directors and shareholders, raises the prospect of divergent goals. Opportunism, conflicts of interest, asymmetric information and uncertainty of outcomes drives and allows this divergence. These risks are minimised through the setting and enforcing of contract terms, remuneration parameters, monitoring performance

and sanctions for poor performance, for example. There remain, however, opportunities for government to complement these measures.

36. Principally, we believe these opportunities arise because markets may not always deliver the transparency and information needed by shareholders and others. There can be barriers to shareholders co-ordinating to seek the corporate governance information they find most useful (the free rider problem).
37. While this information may have been available to, for example, institutional shareholders on request, proposed insider trading and the recently introduced continuous disclosure regulation may reduce access to this information in the future. It is possible the legal obligations around disclosures may in fact detract from the very behaviours we should be seeking to encourage, in particular while the new legislation is being tested.
38. Further, as there are few standards regarding what must be provided, it can be difficult for shareholders and others to compare the corporate governance practices of different entities.

Institute's Preferred Option

39. The Institute proposes that public issuers be required to report against corporate governance principles, or objectives. Other entities would also, of course, be free to disclose how it is that they meet the governance principles.
40. The OECD principles on corporate governance are a good starting point, although we accept there are other good examples. For example, the Australian Stock Exchange Principles (as distinct from the prescriptive reporting requirements that sit beneath the principles) are also relatively good.
41. These objectives should be underpinned by guidance to:
 - Explain what the corporate governance objectives are;
 - Identify barriers and opportunities to achieving those objectives; and
 - Provide examples of good practices.
42. The Institute of Directors, with the assistance of other groups and following consultation, should be invited to prepare that guidance.
43. Our preferred approach is not dissimilar to the Australian, United Kingdom and Canadian “comply or explain” approach in that it allows corporates some freedom to determine for themselves the appropriateness of otherwise of their corporate governance practices. However, it differs in that the focus of public issuer reporting remains on the objectives, not the standards that sit beneath those objectives. This is important. It would mean that:
 - It would not be enough for the issuer to merely disclose that they comply with the code or guidance. Rather, they would need to identify how it is that they achieve the corporate governance objectives.

- If there is a “code” for the issuer to comply with, there is a risk that investors will gain a false and unsafe impression that the regulator is providing an assurance to investors (the moral hazard problem).
 - “One size fits all” is avoided. That is, alternative and better ways of achieving good governance and meeting investor preferences are easily accommodated.
 - Developments in corporate governance are driven by what works, and by what investors want, in preference to what might otherwise be the product of regulatory compromise.
 - The continuing development of better corporate governance practices is facilitated through competition to demonstrate practices that best meet the preferences of investors.
44. Investors, in particular shareholders, would enforce the regime. The information provided would better allow shareholders to judge corporates and to hold them to account. This would be either through making it known to directors what they think of the quality of disclosures and corporate governance practices or, ultimately, by avoiding companies that don’t provide sufficient disclosures or meet their preferences for good practices.
45. This approach would help investors to better identify relative risk from corporate governance practices. Providing greater certainty to investors regarding these risks should in turn reduce the cost of capital for some firms, although it should rise for those firms considered to have poor practices. Further, to the extent that the disclosures promote competition between corporates to better their corporate governance practices, there will be an overall reduction in risk, and with it the cost of capital.
46. With better information, markets are able to take action themselves to correct problems, preferably before they arise.

VI: ALTERNATIVE OPTIONS

47. The Institute rejects the Sarbanes-Oxley approach of prescribing the corporate governance practices of publicly listed companies. And while we view as superior the “comply or explain” approach adopted in the United Kingdom, Australia and Canada, we consider this approach to have many of the same drawbacks as the Sarbanes-Oxley rules based approach. This is because increasingly we are seeing the “comply or explain” approach developing into a “requirement to comply”, that is, de-facto rules based regulation, with all its associated disadvantages. Alan Cameron, former chairman of the Australian Securities and Investments Commission provides a number of Australian examples¹.
48. Rogue companies, directors and management will always find ways to disregard the spirit of rules while claiming they conform to the letter of the law. This type of regulation, by taking away shareholder choice, risks

¹ Jane Diplock, “Corporate Governance Issues”, April 2003.

blunting the incentives on investors to be vigilant in assessing and acting upon risk, and blurs the lines of responsibility.

49. While we can legislate for corporate governance processes, we cannot easily legislate for their effectiveness. We cannot easily prescribe ethical behaviour. This is well illustrated by Enron. In terms of the processes it had in place, Enron could almost have been regarded as best practice.
50. The Governor of the Reserve Bank, Alan Bollard, describes the key disadvantages with the government prescribing corporate governance practices². He comments that:

“We avoid prescriptiveness because we believe it will lead to sub-par performance in the financial sector, for a number of reasons. First, the more behaviour is prescribed, constrained and directed by official agencies, the more likely it is that an implicit government guarantee will be created. Second, excessive prescription may distract executives, leading them to neglect effective risk management and instead merely tick boxes to follow regulators’ rules. Finally, in the extreme, excessive prescription may increase the opportunity for cynical gaming of rules, creating an artifice that may expose the firm to large and poorly understood risks – risks that may end up sinking it altogether.”

51. In commenting on the dangers of a “one size fits all” approach, he goes on to say:

“Moreover, financial activity is becoming increasingly complex, and increasingly challenging regulators’ technical ability to prescriptively regulate financial innovation without causing unintended distortions Finally, the prescriptive mentality militates against the objective of dynamic efficiency, which requires a sufficiently flexible regulatory environment for innovation to flourish.”

52. On the issue of who should set these rules, he comments that:

“However, our view is that directors and executives of financial institutions are best placed to set such rules regarding their own risk management, and that they must take full responsibility for setting appropriate rules in an environment of stringent market discipline and strong measures to encourage self discipline.”

53. The Institute strongly endorses these views and believes the approach we have outlined above to be consistent with Alan Bollard’s comments.

² Alan Bollard, “Financial Sector Regulation in New Zealand”, speech to the Finance Sector Ombudsman Conference, July 2003.

54. Standards of best practice governance vary from one firm to another and over time, investors differ on what they consider to be best practice, and their trade-off between risk and the standards of best practice differs. Government enforcement of a single standard will impede the efficient functioning of the market, to the disadvantage of investors, corporates, employees and consumers.
55. It is correct not to legislate for corporate governance practices. However, we think gains are possible by returning the focus of disclosure to the objectives of corporate governance rather than the guidance or codes that sit underneath those objectives. This will better promote a thinking market – corporates having to make deliberate choices on how they achieve their objectives given the corporate’s individual circumstances, and investors consciously assessing whether those practices are likely to meet their expectations.

VII: ADOPTING OVERSEAS REGULATION

Work of the Institute’s Working Group on Corporate Reporting

56. A number of submitters on the Institute’s review of corporate reporting commented that New Zealand needed to follow other countries in adopting more intrusive and prescriptive interventions if it was to attract and retain investment from overseas, even in the absence of a “New Zealand problem”. The importance of New Zealand following overseas regulatory responses is a theme that has come up increasingly in commentary from the Securities Commission and the Minister of Commerce³, and is a topic worth further examination.
57. The Institute’s working group took the issue of investment from overseas very seriously. Attracting and retaining overseas investment is crucial to New Zealand interests. To ensure it dealt with this issue properly, the Institute commissioned on behalf of the working group a study by Professor Neil Quigley of Victoria University to consider to what extent New Zealand needed to follow overseas regulatory developments if it was to attract and retain investment. Briefly, Professor Quigley found that:
- Differences in regulation and the associated transaction costs of learning are unlikely to be a key determinant of foreign investor participation in NZ capital markets;
 - Regulatory approaches and laws from the larger OECD countries cannot be applied to New Zealand without significant risk of setting standards or imposing industry structures that are inefficient in the context of the small and isolated markets of NZ; and
 - In most cases the benefits of harmonisation are unlikely to be large enough to drive the adoption of overseas regulatory and legal frameworks.

³ See for examples Jane Diplock, *Corporate Governance Issues*, April 2003, and Hon Lianne Dalziel, *Forum on Minter Ellison Rudd Watts’ White Paper on Corporate Governance*, July 2003.

58. Further, in the final analysis, it was the working group's view that the proposed package of reforms they had proposed would keep New Zealand within the "OECD pack" such that investment would not be impacted upon. The Institute supports this conclusion. These and other arguments related to the harmonisation debate are discussed further below.

Promoting Market Confidence

59. An argument in favour of harmonisation is that only by having regimes broadly similar to those within which the overseas investor is familiar, will that investor have confidence to invest in New Zealand.
60. The Institute is not aware of any evidence that overseas investors have, as a consequence of concerns over corporate governance in our listed companies, lost confidence in New Zealand as a destination for investment. In undertaking its corporate reporting exercise, the Institute deliberately chose not to tell investors they had lost confidence in corporate governance and the quality of corporate reporting. Instead we invited investors to tell us whether they had lost confidence. They did not do so.
61. Nor is it our experience that overseas investors are seeking more regulation to encourage them to invest here. In terms of the quality of government, New Zealand is a good place to do business – the political environment is relatively stable, property rights are well protected, contracts enforced, and corruption in government is not an issue investors need be concerned with. In this regard, New Zealand keeps company with countries such as Australia, Canada and the United Kingdom, not Zimbabwe or Vietnam, which must pay investors a significant premium for investment.
62. Further, as commented above, the Institute considers it was systemic overconfidence and complacency in the United States that led to the drop in their corporate governance standards. It is for this reason that our objective has not been simply to promote confidence, but to promote confidence appropriate to the level of market risk. This is an important difference. Only market reforms that are real, that promote an actual reduction in risk should be pursued (having regard to consequential costs).

The Importance of Tackling Real Problems with Real Solutions

63. In a recent speech⁴, the Minister of Commerce identified the following as central to developing good government policy: identification of the problem that needs to be addressed, and assessing whether the benefits of the regulatory regime proposed are likely to outweigh the costs.
64. The Institute fully supports this approach. Cosmetic reforms with little regard for actual problems are a recipe for disaster. Perceptions are difficult to accurately target, and inaccurate targeting could make the situation worse. For

⁴ Hon Lianne Dalziel, Government's Vision for Securities Law Reform Legislation, March 2003.

example, if regulation leads to investors becoming too confident, they may become complacent, thereby increasing the risk of failure.

65. Further, perceptions can be fickle and investors are unlikely to remain fooled by cosmetic regulation. David Lange, New Zealand's Prime Minister in the mid to late 1980s, once compared financial markets to reef fish – easily startled by the shadow of a boat, but quickly returning to normal once the shadow has passed. Targeting perceptions while the shadow is passing could result in the market being stifled by inappropriate and costly regulation once that shadow has passed. While an over-reaction by the market can be quickly corrected, this is not the case with regulation, which is difficult to remove once on the statute books.
66. It is important that the objective of targeting overseas investment not be allowed to substitute for hard policy analysis. Rather, it is important that regulators remain focussed on assessing the nature and magnitude of the problem, identifying and assessing the options to address that problem and amending the final option where necessary for best effect. This is particularly important for a small country like New Zealand, which cannot as easily as large economies afford the cost of poorly conceived and designed regulation. Sound regulation appropriate to New Zealand is, in our view, the best way to attract overseas investment.
67. Finally, while some overseas reforms will be appropriate to the New Zealand environment, others will not. There is no guarantee that their legislation serves their own interests, and there will be even less of a guarantee that they would serve ours. New Zealand must be an astute consumer of overseas regulation if its interests are to be best served.

Many Factors Drive Investment

68. Why should investors spend time and money in learning about the corporate governance environment in a small distant country that will never make up a significant part of a global investment portfolio?
69. The question is worth asking, but it needs to be asked in a wider context. Why should investors spend the time to familiarise themselves with New Zealand's unique investment environment? That environment includes not only our corporate governance regime, but the multitude of other regulations as well as companies, securities, environmental, employment, health and safety, planning, and tax regulation, to name a few.
70. Beyond our regulation, overseas investors will be interested in the quality of our courts, liquidity of our markets, exchange rate risk and what drives that risk (monetary and fiscal settings, and the commodity cycle, for example), the quality of our labour and corporate management, the state of our infrastructure and its ability to accommodate future economic growth (electricity and roads are topical examples), distance from markets, investment options and their prospects and so on and so forth.

71. Within this context, corporate governance regulation is a small consideration for investors and its reform should be driven by real problems.

VIII: PUBLIC SECTOR GOVERNANCE

Introduction

72. The Institute welcomes the Commission extending the debate on governance to include the public sector. It is in the public sector that the greatest need for good governance is found, and that the greatest public benefit gains are possible. This should be the government's priority.
73. We note, however, there are a number of government agencies perhaps better placed than the Commission to advise government on these issues, including Treasury, the State Services Commission, the Office of the Auditor General, and the Ministry of Economic Development.
74. That said, it is unclear to whom the Commission is to provide the information it collects, and how that information might ultimately be applied. We therefore offer the following general comments and suggested options for further consideration.

The problem

75. The power to tax and to regulate is coercive, and in New Zealand their influences are pervasive. At approximately 33 per cent of GDP, the public sector represents a significant burden on the New Zealand economy. Further, too much of New Zealand's regulation is of poor quality. It has been passed with insufficient regard to its impacts, and is detracting from rather than contributing to public welfare. Increasingly regulation is constraining the ability of the business sector to generate necessary income and jobs, for example. Poor governance in the public sector has been a major contributor to this outcome.
76. The public sector operates in the absence of many of the disciplines that force private sector entities to continually develop new and more effective ways of managing risk. For example, performance is often assessed against multiple criteria, value for money is difficult to measure, there is no share price and public sector entities are not subject to take-over and are seldom allowed to fail. By way of example, when Enron and its auditors failed to provide accurate financial information to the market, they were both allowed to fail. This sent a very strong message to the rest of the market. Yet accounting irregularities at Enron and WorldCom are minor compared with many governments' poor behaviours.
77. Governments often choose not to be transparent in their financial operations, notwithstanding the public interest. This is because it is often not in their interests to be so. Even New Zealand, which is comparatively well regarded for its public sector financial management, needs to be on its guard against

poor practice. The Minister of Finance, the Hon Dr Cullen has expressed a desire to focus more on results from core government activities rather than the results in the fully consolidated financial statements (which would include the performance of State-Owned Enterprises consolidated on a line-by-line basis). This is equivalent to Enron's wanting to leave the Special Purpose Entities off its books.

78. The same disclosure based measures that we advocate helping the market work more efficiently cannot be expected to operate effectively in the public sector. As funders of public sector entities, taxpayers can be considered equivalent to shareholders. Yet it is not possible for taxpayers to withdraw their funding from poorly performing entities as shareholders can, or to effectively debate with public sector managers the adequacy of processes they have in place. In this sense, greater disclosures directed at taxpayers will have little impact. Elections are a very blunt instrument for enforcing good corporate governance practices on individual public sector entities.
79. It is for these reasons that governments need to take strong steps to promote effective public sector governance.

Options

80. Options for improving governance in the public sector we believe warrant further consideration include the following:
 - The government could reinstate a comprehensive privatisation programme. In this way significant resources (approximately \$17.8 billion in assets are tied up in SOEs alone) would be subjected to the superior governance disciplines of the private sector. Greater use of contracting out, for example in health and education could also realise significant additional gains.
 - A Regulatory Responsibility Act could be enacted. Among other things, the Act would require the executive to table in the House of Representatives regulatory strategy statements at regular intervals. It would also outline principles of good regulatory practice by which regulation should be judged. This would promote transparency and accountability of the executive for its legislative programme and the results of that programme, thereby promoting open and informed debate on this important area of government. Like its fiscal equivalent, the Fiscal Responsibility Act, the Regulatory Responsibility Act would become an important part of the public sector governance landscape.
 - A Select Committee with specific responsibility for addressing matters of regulatory responsibility could be established. It would be able to call individual government agencies to appear before it and could be mandated to consider the relative costs and benefits of regulatory proposals and compliance with the principles of the Regulatory Responsibility Act.

- The Ministry of Economic Development could move from a monitoring and educative role to also **enforcing** standards of good regulatory practice. Responsibility for ensuring the quality of Regulatory Impact Statements (RISs) could rest with a senior Minister, preferably the Prime Minister as is the case in the United Kingdom. Similarly, consideration could be given to shifting the departmental oversight role for RISs from the Ministry of Economic Development to the Prime Minister’s Department, and ensuring adequate funding.
- The draft RIS could be used to promote more informed and focussed consultation, ie, rather than merely accompanying the cabinet paper or bill later in the policy process.
- The responsible Minister could be required to sign RISs certifying that the principles of regulatory responsibility have been applied in formulating proposal and that the costs imposed on the private sector justify the expected benefits. This is the requirement in the United Kingdom.
- There could be an annual two-hour debate in Parliament on regulatory responsibility.
- A Regulatory Ombudsman, being an independent Officer of Parliament, could be established to receive and consider complaints from the public about the effect of regulation.
- Regulatory Experts Advisory Committee, analogous to the Legislative Advisory Committee, could be established. This would provide advice to the Minister of Commerce on regulatory responsibility matters (including greater scrutiny of secondary legislation).
- The Chief Parliamentary Counsel and the Solicitor-General could formally provide feedback to the State Services Commissioner on the quality of departmental legal advice. This would form part of the Chief Executive’s Performance assessment.
- The government could be required to produce a “regulatory budget”. This would require, for example:
 - that the Government report annually on the current stock of regulations on the books (including primary legislation) of all government agencies;
 - a list of regulations that have been reviewed in the year passed – and a quantitative/qualitative compliance cost statement of aggregate impact of such activity (per department);
 - a projection or plan of the regulations that will be reviewed in the coming year;
 - a forecast of proposed new regulation for the coming year; and
 - a statement of the measures implemented to reduce regulatory costs within government agencies.

IX: OTHER ISSUES: INSTITUTE RESPONSES TO SPECIFIC QUESTIONS

81. The Institute considers it appropriate to reply to only a subset of the questions in the Commission's questionnaire.
82. For the most part, the questions identified by the Securities Commission are best decided by shareholders and directors on a case by case basis. For example, whether a CEO should not go on to become a Chair (Issue two, Question 5) will depend very much on the circumstances surrounding each company. However, if responses to these questions are to be developed into suggested guidance, codes of practice against which corporates must report, prescribed standards, or some other mechanism, the Institute would expect the opportunity to comment on the appropriateness of those standards within that context.
83. Also, some questions sought the views of respondents on the adequacy of current practice. For example, whether Directors' remuneration is currently set at a level to attract and retain individuals who will make a significant contribution to company performance (Issue 5, Question 2). These questions are subjective, and to the extent that they might provide information of value to government, they are best answered by directors, shareholders and executives, and for these reasons the Institute has not offered an opinion.

Issue Two

Question 10: In general, do you believe current mechanisms which enable shareholders to assess the performance of boards/directors are adequate? If not, how would you suggest these be improved?

84. As outlined above, the Institute considers public issuers should be required to report against key corporate governance principles, or objectives. These objectives would be underpinned by guidance to:
- Explain what the corporate governance objectives are;
 - Identify barriers and opportunities to achieving those objectives; and
 - Provide examples of good practices.

Question 11: Some commentators suggest that certification or accreditation of directors should be encouraged. What is your view on this?

85. In some circumstances boards and shareholders may value an accreditation scheme (or schemes) for directors for the additional information it provides. The market should ultimately determine whether that scheme adds value, and it should also drive changes to that scheme. In many circumstances, accreditation will not provide boards or shareholders with value, and were it mandatory it could act as a barrier to very capable directors taking up directorships. For these reasons, any accreditation scheme should be voluntary.

Issue Four

Question 1: Continuous disclosure has been a requirement for publicly listed companies in New Zealand since December 2002. In relation to good Corporate Governance, are there any areas or matters on which you believe additional disclosure should be encouraged?

86. As outlined in Part V above, the Institute considers public issuers should be required to report against key corporate governance principles, or objectives. Disclosure should be by way of the annual report. We do not see the need to provide for it as part of the continuous disclosure regime. To do so would add little value, and may impede companies improving their practices over the course of the year if they are required to disclose those changes as part of the continuous disclosure regime and in compliance with the regime's legal requirements.

Question 3: There has been debate in New Zealand around whether listed companies should report quarterly, as required on some US markets. What is your view?

87. Some listed companies already report quarterly, for example, some retail companies. This is demanded by their shareholders. However, there is less need for other companies to do so, and in the context of continuous reporting, we can see little purpose in requiring it of other companies.

Question 4: It is the requirement in some markets for the company CEO and CFO to publicly certify the accuracy and completeness of financial statements. Do you think this is appropriate in the New Zealand market?

88. There may be merit in this proposal. One difficulty is that it may disperse and weaken the current responsibilities of the auditors and the board, as provided for by the Financial Reporting Act 1993, to ensure and certify the integrity of the information. The current convention in New Zealand is for the Chair and the managing director to sign off the financial statements.
89. The Institute does not have a strong view on this proposal.

Question 6: What is your perspective on the proposition that companies should report on their performance against accepted principles of good corporate governance, or explain why they haven't?

90. This question highlights to us the confusion around "principle". The Australian, Canadian and United Kingdom "comply or explain" approaches do not require reporting against principles. Rather, they require reporting against the prescriptive codes that sit beneath those principles. The Institute prefers reporting directly against the principles, but under this option there is no "explain why they haven't" requirement.

Issue Five

Question 5 (b): Should shares or options be expensed against company earnings?

91. The issuing of share options to management and directors has, in part, been blamed for encouraging corporates to look for opportunities to show earnings in the best possible light and encouraging a short-term view at the expense of the corporate's long-term interests.
92. The Institute agrees that, when used excessively or inappropriately, share options can create unacceptable risks to corporate reporting. Share options are, however, a useful tool for aligning the interests of management and directors with those of shareholders. Prescriptive controls on their use would place these benefits at risk. Rather, shareholders and creditors must be vigilant in the way share options are used.
93. Currently, New Zealand share options need not be expensed against revenue, ie, they are not recorded as a cost to the corporate, although the issuing of share options must be recorded in the notes to the accounts.
94. The Financial Reporting Standards Board issued for comment a standard on the recognition, measurement and disclosure of share based payments (ED 93: Share based payments). The standard proposes that all share based payments be recognised as expenses in the statement of financial performance. The Institute supports this treatment of share based payments.

Issue Seven

Question 1: There is international debate about whether audit firms should be rotated from time to time.

(a): To what extent do you consider rotation appropriate in the New Zealand context?

(b): If appropriate: How often should audit firms be rotated?

95. Some submitters to the Institute's corporate reporting review argued audit firm rotation was necessary to reduce the risk of over familiarity and complacency that might come from a long relationship with an audit client. Further, it was argued that knowing one's work was to be reviewed by the incoming auditor provides an effective spur to ensure the quality of that audit.
96. Submitters were agreed that the proposal would add to audit costs. However, a significant number commented that rather than add to the quality of audit, compulsory rotation would reduce audit quality, in particular for large and complex firms. This was because it takes time for a new auditor to become familiar with the processes and business of a client, and this is when the risk of audit failure is greatest. Further, auditors, in knowing they would be rotated off the audit, may have less incentive to deliver a quality product.
97. For larger corporates, rotation would reduce the number of firms competing for any one client from four to three, placing at risk the quality of service and lower costs that come from competition. Where conflicts of interest arise, the

number of firms competing to provide audit services would be even less. This issue could be particularly important outside the major commercial centres in New Zealand.

98. The research presented to the Institute's working group, while inconclusive, identified a higher occurrence of audit failure in the first two years of an audit engagement. The working group was not presented with any research to suggest compulsory rotation would improve the quality of audit. Of the three countries that had tried audit firm rotation, Italy, Spain and Turkey, only Italy has persevered with it, and that country's experience offered little support for the practice. Ireland, Australia and the United Kingdom have recently reviewed, and decided against introducing audit firm rotation.
99. The Institute's working group concluded that compulsory audit firm rotation would penalise the majority of audit clients and add value in only very limited circumstances. For this reason, they concluded that rotation should not be mandatory. The Institute supports this position.

Question 2: There is also debate suggesting that audit partners should be rotated from time to time.

(a) To what extent do you consider this appropriate in the New Zealand context?

(b) If appropriate, how often should audit partners be rotated?

100. The majority of submitters who commented to the Institute on compulsory audit partner rotation supported the option.
101. The Institute agrees with those submitters who commented that it was the audit partner who is most at risk; becoming complacent after undertaking audits for a client for a long period, or being vulnerable to pressure to produce a 'compliant audit'. Audit partner rotation is a practical way to counter-balance these risks without imposing excessive costs.
102. Submitters differed on whether the rotation period should be five or seven years. The Institute does not view the difference to be material, but favours seven as this will better accommodate the relatively small size of New Zealand's market.
103. The Institute has amended its code of ethics to require rotation of lead engagement partners for audit clients that are issuers after no more than seven years. The Institute does not consider there to be a need for additional requirements at this stage.

Question 3: There are concerns over audit firms also providing other services to client companies.

(a) In your view, what types of non-audit work should be of concern in the New Zealand context (e.g. valuation services, executive recruitment)?

(b) Do you think disclosure of fees paid to audit firms should differentiate between types of non-audit work?

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

Restrictions on non-audit services provided by auditors to audit clients

104. This practice has arisen for good economic reasons. Audit clients value the additional services provided by firms that already have a good understanding of their business. Supplying these additional services may also give the audit firm a greater understanding of their client's business, thereby improving the quality of the audit. Further, economies in scale and scope from providing both audit and non-audit services will reduce costs.
105. The Institute accepts that risks to independence come with auditors providing non-audit services to their clients. This is particularly so where an auditor:
- audits their own work;
 - performs management functions; or
 - acts as an advocate for their client.
106. It is appropriate that limits be placed on auditors undertaking these activities. The key challenge is to devise limits that are not arbitrary, prescriptive, likely to impede beneficial market innovation or impose excessive costs. To this end, the Institute considers its code of ethics, which follows closely the International Federation of Accountants (IFAC) Code of Ethics, to have struck the appropriate balance.
107. The standards are principle-based. Guidance and examples to aid in identifying, minimising and avoiding threats to independent audits are provided. The working group supports the IFAC Ethics standards as the basis for New Zealand's regulation of auditor independence. This is consistent with the approach taken in Australia, the United Kingdom and the European Community.
108. The standards require the identification of any threat created by the provision of non-audit services, and safeguards to eliminate or reduce that threat to an acceptable level. Safeguards include:
- Making arrangements so that personnel providing such services do not participate in the assurance engagement;
 - Involving an additional member to advise on the potential impact of the activities on the independence of the firm and the assurance team; or
 - Other relevant safeguards set out in legislation.
109. Further, the standard identifies activities that would generally create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threat to an acceptable level. These activities include:
- Authorising, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so;
 - Determining which recommendations of the firm should be implemented;

- Reporting, in a management role, to those charged with governance; and
- Any other activity barred by legislation (for example, a liquidator, or a receiver).

Complete prohibition on non-audit services

110. Some submitters argued against audit firms providing audit and non-audit services concurrently to the same client. This practice was considered to exacerbate the conflict of interest inherent in auditors seeking to retain their clients while meeting their obligation to provide independent assurance.
111. Alternatively, other submitters argued that:
- Many non-audit services are audit related and a prohibition would detract from audit quality by reducing the knowledge of the client’s business;
 - Synergies between audit and some other services would allow cost savings to the corporate; and
 - Reducing the scope of work undertaken by auditors would reduce the ability of audit firms to attract and retain quality staff, compromising audit quality.
112. Empirical research considered by the Institute’s working group was divided on whether a complete prohibition would enhance or detract from the quality of audit. Although many countries have or are about to take steps to restrict the type of non-audit services that can be provided to an audit client, the working group is not aware of any country that has pursued a complete audit/non-audit prohibition.
113. The Institute agrees that the provision of some non-audit services to an audit client has the potential to create unacceptable conflicts of interest for the auditor. Self-review is one area where it is important that restrictions and safeguards are applied. The Institute does not, however, consider that New Zealand should impose more onerous restrictions on the provision of audit and non-audit services than any other country. To do so risks significantly adding to audit costs, while even more importantly, reducing the quality of audit in New Zealand.

Disclosure of Audit Fees

114. Section 16 of the Financial Reporting Act 1993 requires that the audit report states the existence of any relationship (other than that as auditor) which the auditor has with, or any interest which the auditor has in, the reporting entity or any of its subsidiaries. The Institute also applies this requirement to auditors of entities other than reporting entities.
115. Further, FRS-9, 6.13(e) provides that the annual report must disclose, among other things, fees paid to “the auditor(s) of the parent entity for other services provided to group entities by the auditor(s) or entities related to the auditor(s)”.

116. In the United States the Securities and Exchange Commission (SEC) released guidance on the disclosure of fees paid to auditors. Disclosure is required against four categories:
- Audit
 - Audit-related fees
 - Tax fees
 - All other fees.
117. Definitions of the four categories are provided in the SEC guidance on disclosure. Other than for the audit fees category, the issuer is required to describe in qualitative terms the types of services provided under the other three categories.
118. All submitters who commented upon the issue of disclosure of non-audit services provided to audit clients supported increased disclosures. While corporates are responding to the greater demand for disclosure in the wake of the reporting failures in the United States, the Institute’s working group considered additional disclosure standards would promote comprehensive coverage and aid comparability of information provided. The Institute supports this conclusion.
119. The Institute’s working group recommended that the Government amends section 211(1)(j) of the Companies Act 1993 and any consequential amendments as necessary, to require mandatory disclosure in the annual report of fees paid for all non-audit services provided against the following categories:
- Audit;
 - Audit-related fees;
 - Tax fees; and
 - All other fees.
120. The working group also recommended that a qualitative description be provided describing the services provided under each of the above categories.
121. The Ministry of Economic Development is considering these recommendations.

Limits on proportion of total fees from a single client

122. The Institute’s code of ethics was recently amended to require audit firms to identify threats to their independence resulting from being too reliant on fees from one client, and, where identified, put in place safeguards to reduce that threat to an acceptable level. Safeguards include taking steps to reduce dependency on the client and external quality control reviews.
123. Intrusive and prescriptive limits could unacceptably reduce the ability of second tier audit firms to compete with the “Big Four” accounting firms and are not favoured by the Institute at this point.

Question 4: It has been argued that board and/or board audit committees should develop and disclose policies for handling complaints by auditors or internal “whistleblowers”. Do you agree or disagree?

124. 'Whistleblowing' is covered by the Protected Disclosures Act 2000. Auditors can make disclosures under the Protected Disclosures Act as 'employees.'
125. Although the Protected Disclosures Act does not require private organisations to adopt disclosure processes, the fact that the Act requires such processes to be followed if they are in place and publicised encourages organisations to adopt disclosure policies. Also the Act has default procedures for people to follow in the event that organisations do not have a disclosure policy.
126. Further, members of the Institute have a duty to report immediately suspected defalcation and dishonesty to the Institute, except where the member receives the information on which the suspicion is based in circumstances of professional confidence. It is important to note that external accountants and auditors do not have legal privilege in New Zealand, thus while there is a 'professional' obligation to uphold client confidentiality, this does not extend to formal interactions concerning money laundering (and other criminal matters).
127. The Protected Disclosures Act is currently under review, the report of which is due out shortly. This is the most appropriate forum for considering reform in this area. That said, the Institute considers that although there may be minor room for improvement, the Protected Disclosures Act provides sufficient protection for internal 'whistleblowers'.

Question 5: In the US and Australia, audit oversight bodies – independent of the profession – are required. There is debate around whether such a body is required in New Zealand. What are your views on this?

128. The Institute understands this issue is being considered by the Ministry of Economic Development, and is unclear why it has been included as part of the corporate governance review. We do, however, offer the following comments based on the Institute's review of corporate reporting.
129. The majority of submitters to the Institute's corporate reporting review opposed the establishment of some type of independent supervisory board, arguing that its cost would be excessive relative to its benefits, and that it would be difficult to find sufficiently qualified and experienced members free of conflicts of interest to serve on it.
130. Establishing a new regulatory body is a significant and costly step that should not be rushed unnecessarily. Further, there is a range of overseas models from which to choose. Many of these (Canada, Australia, the United States and the United Kingdom, for example), have not yet, or have only just been put in place. It is not yet possible to assess which approach is best for New Zealand.

131. Further, the Institute has taken a number of steps to improve practice review and its disciplinary procedures. This has included adopting the working group recommendations to make practice review and Institute enforcement more effective. It is against this “enhanced Institute model” that an independent body should be considered.

Other Issues

Question 1: New Zealand opinion appears to favour a principles versus rules-based approach to corporate governance. Do you believe this is the most appropriate approach for New Zealand?

132. Yes, for the reasons discussed extensively above.

X: PROCESS

133. The Institute considers there are a number of risks to the Securities Commission being able to derive information that will be of value to government decision-makers. Our concerns with the process are as follows:

Problem and Option Identification and Assessment

134. As commented upon in paragraph 63 above, the Institute fully supports the Minister of Commerce’s comment on the importance of careful problem definition and cost benefit assessment of options. The Commission’s paper devotes little to problem definition, and has not asked submitters to comment on what they view as the key problems. Nor does the Commission outline or provide any assessment of potential options for achieving appropriate levels of corporate governance. Information on these issues would have helped submitters to provide comment of greatest value.

Institute’s Corporate Governance Option not Identified and Consultation with Institute

135. The Institute is disappointed that the Commission has chosen not to outline for public discussion the corporate governance option outlined by the Institute’s working group. We are also disappointed that there has been little constructive contact between the Institute and the Commission in the development of the material upon which it is consulting. This contrasts with, for example, the Ministry of Economic Development officials who have met with the Institute to discuss the recommendations arising from the Institute’s working group and to seek further information.

Absence of Clarity on Proposed Use of Regulation

136. From the introductory material provided by the Commission it would be reasonable to infer that the Commission was seeking to develop principles of corporate governance, perhaps accompanied by guidance which entities could adopt if they chose. In the introduction, for example, it is stated that “The

focus of this project is not law reform.” However, a number of questions, for example, Issue Four, Question 4 asks:

“It is a requirement in some markets for the company CEO and CFO to publicly certify the accuracy and completeness of financial statements. Do you think this is appropriate in the New Zealand market?”

137. This question is asking respondents to provide their views on whether they consider New Zealand should adopt regulatory requirements currently in place overseas. The information received in response to this question can only be of value to informing a decision on whether to regulate in New Zealand.
138. Further, on 22 September 2003, the Minister of Commerce was quoted in the Herald saying that regulation was a possible outcome of the Commission’s corporate governance exercise. In response, the Institute considered it necessary to clarify with the Minister the range of possible outcomes from the review. The Minister confirmed that legislation was an option.
139. At a generic level, it is unclear whether, with respect to each question, submitters are being asked to comment on a practice as if it might become, for example:
- A prescriptive regulatory requirement;
 - Regulation requiring entities to report whether they comply with prescriptive corporate governance practices, and where they do not, explain why not - “comply or explain”;
 - Regulation requiring entities to report how it is that they achieve corporate governance principles or objectives, accompanied by guidance on how those objectives might be achieved; or
 - Guidance that entities comply with at their discretion.
140. It is important that where regulation is being contemplated this, and the type of regulation, be made explicit. For example, while the Institute considers it good practice for public issuers to separate the position of Chief Executive and Chair, we do not consider this should be legislated for. Our support is, in this instance, conditional on it not being legislated.
141. Where submitters have confirmed support for the measures the Commission has sought comment on, but have not said whether they favour legislation or voluntary compliance, we suggest it be assumed they favour voluntary compliance. This is because the introductory material provided with the questionnaire suggests legislation is not an option, making it the sensible default option.

Confusion over the Meaning of “Principle”

142. In the introductory material the Securities Commission emphasises the use of non-prescriptive principles. The Institute supports this approach. However, we are unsure if we are using the term in the same way as the Commission.

143. Principle based requirements are also known as “performance”, or “outcome” based requirements. This type of regulation specifies the standard to be met, but not **how** that standard is to be achieved. Occupational health and safety and environmental/conservation regulation provide examples of this type of regulation. The IFAC auditing standards are, for the most part, principle based.
144. By way of example, to control weather tightness traditional regulation might specify the type of building material to be used, acceptable building designs and who may build the structure. Performance based regulation might require that the structure retain weather-tightness for 20 years. It is for the company to decide how best to achieve this outcome. For many, but not all types of performance based regulation, a regulator determines whether the standard has been met.
145. Performance based reporting is analogous to the government’s greater focus on “outcomes” in preference to “inputs” and “outputs” with regard to its own governance arrangements. There are many advantages to this approach, the key being it allows those who must meet those standards to innovate to find the best and least costly way of meeting those standards.
146. From this, our idea of a principle is synonymous with “objective”. In this case, it is the targets to which good corporate governance is directed, for example, systems appropriate to:
- Creating shareholder value;
 - Protecting and promoting shareholder rights;
 - Providing information by which people are able to judge corporate performance and hold the corporate to account;
 - Ensuring compliance with the law;
 - etc
147. Almost without exception, the requirements the Commission is seeking comments on are the traditional “input or rules-based” requirements. It is difficult to reconcile this with the stated intent of producing corporate governance principles.

Leading Questions

148. A number of the questions are leading. For example, Issue Five, Question 1:
- “Internationally, there is a trend to explicitly link directors’ remuneration with company performance. To what extent do you think this should be the case in New Zealand?”
149. A neutral question would have been:
- “To what extent do you think directors’ remuneration should be linked to company performance?”

Range of Entities Principles are to Apply to

150. Submitters are being asked to comment on the range of entities to which the principles should apply, eg:
- Subsidiaries of overseas companies;
 - Supplier or purchaser owned cooperatives;
 - Widely held unlisted companies;
 - Government and local authority owned entities;
 - Closely held or family owned companies;
 - Etc
151. This needs to be considered on a case by case basis, and against the 65 questions asked, will be very difficult for submitters to respond to.
152. Also, we note that if the government approach is to provide principles which entities may comply with if they choose, the entities will self-select, that is, only if there are to be legislative requirements is it necessary to specify which entities the principles should apply to.

Consensus on Principles

153. The Commission states that it intends to present to the Minister of Commerce a set of broad Corporate Governance Principles around which there is broad based consensus. The Commission neither presents principles for discussion, nor invites submitters to comment on what they view as appropriate principles. Logically, without a further round of consultation it will not be possible to claim any sort of consensus for the principles presented to the Minister.

154. For the reasons outlined above, the Institute recommends that public consultation on options for promoting appropriate levels of governance in New Zealand be undertaken prior to making final decisions. We believe this will be necessary to bring together information necessary for developing good policy and to secure buy-in to any subsequent reforms.